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**No More Parking Lots: How the Tax
Code Keeps Trees Out of a Tree
Museum and Paradise Unpaved**

by

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NO MORE PARKING LOTS: HOW THE TAX CODE KEEPS TREES OUT OF A TREE MUSEUM AND PARADISE UNPAVED

Francine J. Lipman*

I. INTRODUCTION

They took all the trees put 'em in a tree museum
And they charged the people a dollar and a half just to see 'em
Don't it always seem to go
That you don't know what you've got till it's gone
They paved paradise and put up a parking lot.

—Joni Mitchell, "Big Yellow Taxi"¹

"Natural forestland is a precious and unique resource within the United States."² From 1970 to 1998, nearly twenty million acres of rural land were paved over and developed.³ "In America today, some 365 acres of farms and forests are bulldozed into malls and subdivisions and parking lots every hour."⁴ As open space disappears at an accelerating pace,⁵ the public has an increasing interest in the management of forest land.⁶ However, a

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¹ Joni Mitchell, *Big Yellow Taxi*, on LADIES OF THE CANYON (Warner Brothers 1970), available at <http://www.jonimitchell.com/Ladies70LyricsHome.html> (setting forth lyrics to *Ladies of the Canyon* album including lyrics to "Big Yellow Taxi" song) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

² Thomas Lundmark, *Methods of Forest Law-Making*, 22 B.C. ENVTL. AFF. L. REV. 783, 783 (1995).

³ See Sierra Club, *Sprawl: The Dark Side of an American Dream*, <http://www.sierraclub.org/sprawl/report98/report.asp> (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

⁴ Vicki Elkin, *Every Community has a Walden Pond*, CROSSCURRENTS (Gathering Waters Conservancy, Madison, Wis.), Winter 2002, at 2 (quoting Peter Forbes's comments at 2002 Land Trust Rally, which drew a record attendance of 1800 land trust professionals and volunteers).

⁵ "Everyday throughout the nation, productive cropland is being replaced by highways, gas stations, strip malls, reservoirs, billboards, parking lots, bigger and uglier buildings, and, generally, unmanageable urban growth." David L. Szlanfucht, *How to Save America's Depleting Supply of Farmland*, 4 DRAKE J. AGRIC. L. 333, 333-34 (1999). "For example, Iowa has lost nearly one million acres of its farmland from 1974 through 1994 and more than one-third of that has been lost since 1991." *Id.* at 337. Similarly, "Ohio is losing ten acres of farmland per hour," and approximately ten percent of its entire loss has occurred over the past twenty years. *Id.*

⁶ See Ian Bowles et al., *Economic Incentives and Legal Tools for Private Sector Conservation*, 8 DUKE ENV. L. & POL'Y F. 209, 209 (1998) (noting that "public concern about

significant portion of the more than 700 million acres of United States forest land is privately owned.⁷ To reconcile the conservation interests of the public sector and the economic interests of the private sector, the government has developed economic incentives to advance natural resource conservation and preserve private owners' economic interests.⁸

Many government economic incentives for forest land management are structured as tax benefits.⁹ Tax benefits are an effective and efficient gov-

environmental issues like . . . overconsumption of natural resources, and worldwide loss of tropical forests has grown explosively and led policymakers to devote more attention to these issues"); *see also* Thomas N. Lippe and Kathy Bailey, *Regulation of Logging on Private Lands in California Under Governor Gray Davis*, 31 GOLDEN GATE U. L. REV. 351, 352 (2001) (stating that "[f]ew issues in California have been more controversial or engendered more passionate public debate than the damage to the state's environment from logging"); California Wilderness Coalition, *Bush Signs Big Sur Wilderness Bill*, 63 HI SIERRAN 22 (2003) (quoting Campaign Director for California wilderness bill as stating "[n]early three in four California voters support permanent protection of more wilderness and scenic rivers").

⁷ Approximately twenty-eight percent of the land in the United States, or more than one million square miles (726 million acres), is classified as forest and woodland. More than 500,000 square miles (348 million acres) of this land is held as private commercial timberland. *See* Lundmark, *supra* note 2, at 784 (citing as references Thomas W. Birch, Douglas G. Lewis, et al., *The Private Forest-Land Owners of the United States* 7 (Forest Service Resource Bulletin WO-1, 1982) and United States Bureau of the Census, Statistical Abstract of the United States 679 at tbl. 1150 (1993)). For instance, the redwood forests of California are for the most part owned by private interests. Lippe and Bailey, *supra* note 6, at 352; *see also* WIS. DEP'T OF NAT. RESOURCES, WISCONSIN VOLUNTARY SITE-LEVEL FOREST MANAGEMENT GUIDELINES, PRELIMINARY FIRST EDITION 6 (2002), available at <http://www.dnr.state.wi.us/org/land/forestry/Private/FMG/completeFMG.pdf> (stating that private, individual owners hold fifty-seven percent of Wisconsin's 16 million acres of forest land) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review); Edith M. Kadlec, *A Lakeside Legacy*, 6 COMMON GROUND 2 at 5 (2002) (noting that eighty percent of the land bordering Wisconsin's lakes and rivers is privately owned and already developed).

⁸ *See* Bowles et al., *supra* note 6, at 209. In 2002, voters approved 139 (out of 188) ballot measures generating approximately \$10 billion (\$6.9 billion of which was approved on November 5) in local and state funding for conservation and related activities, including \$5.7 billion for land protection. This funding will support state and local economic incentives to advance natural resource conservation—primarily open space protection. Land Trust Alliance, *Voters Approve \$2.9 Billion for Land Conservation*, available at http://www.lta.org/newsroom/pr_110602.htm (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review). On May 13, 2002, President George W. Bush signed into law The Farm Security and Rural Investment Act of 2002 ("The Farm Act") providing billions of dollars for conservation purposes, which, among other things, will support economic incentives for land preservation, and permanently authorize an agency to support state, local and nonprofit organization natural resource conservation programs. Pub. L. No. 107-171, 116 Stat. 133, available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR02646:ITOM:bss/d107query.html> (last visited Apr. 22, 2003). The Farm Act "increases mandatory spending for conservation by eighty percent, providing \$12.9 billion in new spending over the next six years." Beth Bier, *Update on Farm Bill*, CROSSCURRENTS (Gathering Waters Conservancy, Madison, Wis.), Fall 2002. The Farm Act permanently authorizes the Resource Conservation and Development Program, an agency that "helps improve the capability of state, tribal and local units of government and local nonprofit organizations in rural areas to plan, develop and carry out programs for natural resources conservation and development." *Id.*

⁹ *See* Lundmark, *supra* note 2, at 797–802.

ernment tool to manage private interests because they employ existing and well-developed determination and delivery systems—our federal and state income and property taxes.¹⁰ Moreover, because income tax systems in particular usually are self-determining, self-reporting, and self-assessing,¹¹ taxpayers spend their own time, energy and processing costs to receive their tax benefits.¹² The government saves the substantial costs of creating, implementing, supporting, and enforcing a new direct regulation system.¹³ As a result, tax incentives are practical public tools used to impact private forest management decisions.¹⁴

With a record boom in real property market values and an imminent bust in the perceived real estate bubble,¹⁵ now may be the time for private owners of forest land to take advantage of tax incentives. Increased property market values may generate enhanced tax benefits that property owners can enjoy without selling, developing, or encumbering their property. For instance, conservation easements¹⁶ can provide lucrative tax benefits meas-

¹⁰ *Id.*

¹¹ Jeffrey L. Yablon, *As Certain as Death—Quotations About Taxes (Expanded 1997 Edition)*, 77 TAX NOTES 1485, 1504 (1997) (Quoting John F. Kennedy as saying, “One of the major characteristics of our tax system and one in which we can take a great deal of pride, is that it operates primarily through individual self-assessment.”) The United States federal income tax system relies on taxpayers to self-determine, assess, and report their annual income tax liability and any amount payable or refund due for every tax year. See I.R.C. §§ 6011, 6012, 6072 (2000).

¹² See Lundmark, *supra* note 2, at 798.

¹³ See *id.*

¹⁴ Ron Singleton & James J. Jurinski, *The Effects of Tax Policies on Forestry Practices*, 40 OIL & GAS TAX Q. 763, 784 (1992) (studying “the impact of taxes on the investment, operating, and cutting decisions of timber owners” and concluding that “governments can have an impact on forest management practices through their tax policies”).

¹⁵ See M. Corey Goldman, *The Money Trap, Safer Than the Stock Market, But Will It Appreciate?* (Aug. 27, 2001), at http://abcnews.go.com/sections/business/DailyNews/housing_sidebar_010827.html (last visited Oct. 11, 2002) (on file with the Harvard Environmental Law Review); Bill Redeker, *Living in a Bubble: Housing Experts Warn Some Real Estate Markets Are Overpriced* (Sept. 5, 2002), at http://abcnews.go.com/sections/business/DailyNews/redecker_housingbubble_020905.html (last visited Oct. 11, 2002) (on file with the Harvard Environmental Law Review); Peter Hartcher, *Fed Blamed for US Real-Estate Bubble*, FIN. REV., June 27, 2002, at <http://afr.com/world/2002/06/27/FFXL7MR3W2B.html> (last visited Oct. 11, 2002) (on file with the Harvard Environmental Law Review).

¹⁶ A conservation easement is a voluntary agreement between a landowner and the easement holder to restrict development on her property. See Kemble H. Garrett, *Conservation Easements: The Greening of America?*, 73 KY. L.J. 255, 257 (1984–85). Conservation easements are usually “negative easements in gross” because they give the easement holders the right to restrict the landowners’ development of the land regardless of whether the easement holder owns any neighboring land. *Id.* Some conservation easements are both negative and affirmative if the public is given access to the land or the easement holder is allowed to enter the land to maintain the terms of the easement. See Ross D. Netherton, *Environmental Conservation and Historic Preservation Through Recorded Land-Use Agreements*, 14 REAL PROP., PROB. & TR. J. 540, 560 (1979). Conservation easements offer attractive incentives and characteristics for forest landowners and environmentalists. Jeffrey Tapick, *Threats to the Continued Existence of Conservation Easements*, 27 COLUM. J. ENVTL. L. 257, 259–60 (noting that “[c]onservation easements are created through voluntary, free market transactions between landowners and easement holders”). “[L]and subject to a conservation easement may be freely sold, donated, passed on to heirs, and transferred

ured by the decrease in the fair market value of the property after imposition of the easement.¹⁷ With skyrocketing real estate values, this decrease may be considerable, resulting in greater tax benefits than before the record real estate boom. Additionally, with plummeting stock market values,¹⁸ harvesting the appreciation in real property—rather than the depreciation in stock market values—is a preferred economic alternative.¹⁹ Most significantly, federal, state, and local governments concerned with the disappearance of open space, suburban sprawl, and traffic jams provide major tax benefits to encourage forest landowners to preserve rather than develop their property.²⁰

in every normal fashion, so long as the land remains subject to the restrictions of the easement.” C. Timothy Lindstrom & Stephen J. Small, *New Estate Tax Relief for Land Under Conservation Easement*, 78 TAX NOTES 1171, 1172 (1998). The Senate stated that the estate tax benefits of conservation easements were to “ease existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes, and will thereby help to preserve environmentally significant land.” S. Rep. No. 105-33, at 46 (1997); Stephanie L. Sandre, Note, *Conservation Easements: Minimizing Taxes and Maximizing Land*, 4 DRAKE J. AGRIC. L. 357, 360–61 (Spring, 1999) (noting that farmers can enjoy the lucrative tax benefits of conservation easements and continue to retain significant rights in the land including the right to use and sell).

¹⁷ See Treas. Reg. § 1.170A-14(h)(3)(ii) (2002).

¹⁸ See Alex Berenson, *Wall St. Down a 3rd Year Leaving Fewer Optimists*, N.Y. TIMES, Jan. 1, 2003 (noting that the U.S. stock market plunged in 2002—more than in either of the two prior years, marking a three-year consecutive decline for the first time in sixty years—and the Standard & Poor’s 500-stock index posted its worst year since 1974).

¹⁹ The old adage “buy low, sell high” means that under current economic conditions appreciation in real property should be harvested and stock investments should be planted. See Andrew Leckey, *Real Estate Investments Prospering Despite Downturn*, The Bull & Bear Financial Report, at <http://www.thebullandbear.com/articles/2002/0802-leckey-re.html> (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review); cf. Sy Harding, *Does Real Estate Beat the Stock Market?*, The Bull & Bear Financial Report, at <http://www.thebullandbear.com/articles/0402-harding.html> (last visited Oct. 11, 2002) (on file with the Harvard Environmental Law Review); Dean Baker, Center for Economic and Policy Research, *The Run-Up in Home Prices: Is it Real or is it Another Bubble?* (Aug. 5, 2002) (noting that the increase in housing prices has increased wealth by more than \$2.6 trillion or an average of \$35,000 for each of the nation’s 73.3 million homeowners). Conservation easements provide an opportunity to “harvest” appreciation through deductible charitable contributions without relinquishing ownership. See Stephanie L. Sandre, Note, *Conservation Easements: Minimizing Taxes and Maximizing Land*, 4 DRAKE J. AGRIC. L. 357, 360–61 (1999).

²⁰ See Karen M. White, Note, “Extra” Tax Benefits for Conservation Easements: A Response to Urban Sprawl, 18 VA. ENVTL. L.J. 103, 104–05 (1999) (stating that given America’s diminishing open space and rapid development and expansion of suburbia, tax incentives to create conservation easements serve as a useful tool in combating the problem of urban sprawl); Laura S. Beliveau, Comment, *The Forest Legacy Program: Using Conservation Easements to Preserve the Northern Forest*, 20 B.C. ENVTL. AFF. L. REV. 507, 520 (1993) (noting that Congress in 1964 enacted a tax incentive for the charitable donation of a landowner’s development rights); John M. Vandlik, *Waiting for Uncle Sam to Buy the Farm . . . Forest, or Wetland? A Call for New Emphasis on State and Local Land Use Controls in Natural Resource Protection*, 8 FORDHAM ENVTL. L.J. 691, 693–700 (1997); David L. Szlanfucht, Note, *How to Save America’s Depleting Supply of Farmland*, 4 DRAKE J. AGRIC. L. 333, 343–46 (1999) (noting that Congress and most states encourage the use of conservation easements by creating tax incentives including income and estate tax deductions and that the Lancaster Farmland Trust has preserved 100 farms and 6500 acres of farmland for perpetuity); Kari Gathen, Comment, *The Use of Conservation Easements to*

Forest landowners can receive tax benefits for reforestation expenditures,²¹ tax-free payments under forestry incentive programs,²² and reduced tax rates on income from timber harvests.²³ In short, economic and tax conditions are ripe for owners of forest land to capture their increased market values and to continue to own and enjoy the economic and aesthetic benefits of forest landownership. The current environment may also be optimal because planned decreases in marginal tax rates will cause these tax benefits to be less valuable in future years.

This Article will discuss and analyze the various tax incentives available to private owners of forest land who desire to preserve their property and maximize their economic interests. In Part II, the Article will present five tax benefits specifically targeting owners of forest land. The first two involve reforestation expenditures. First, forest landowners are allowed to amortize rather than capitalize up to \$10,000 of qualifying reforestation expenditures.²⁴ Second, the reforestation tax credit, provides a ten percent tax credit for amortizable reforestation expenditures.²⁵ The third category of tax benefits relates to the preferential long-term capital gain treatment for the sale or cutting of timber.²⁶ Forest landowners qualifying for this benefit can notably reduce their tax costs on income from their timber harvests. The fourth tax benefit presented is a forest landowner's ability to exclude government reimbursements and cost-share payments from taxable income.²⁷ The fifth, and final, tax benefit is the conservation easement. If a forest landowner voluntarily enters into a personalized qualifying conservation easement on her property, she can enjoy significant income, estate, and property tax benefits. In some cases these tax benefits will far exceed any reduction in fair market value.²⁸

Part III of the Article provides a hypothetical example illustrating how each of these five tax benefits works in practice. The example demonstrates how these tax benefits can help to align the interests of private forest landowners and conservationists.

Part IV presents the conclusion that the tax benefits Congress has enacted can provide private forest landowners with significant economic incentives to achieve public environmental conservation goals.

Preserve New York State's Natural Resources, 7 ALB. L. ENVTL. OUTLOOK 188, 189 (2002) (finding that conservation easements may result in reductions of inheritance, income, and property taxes).

²¹ See I.R.C. §§ 48(b), 194 (2000).

²² See I.R.C. § 126(a) (2000).

²³ See I.R.C. § 631 (2000).

²⁴ I.R.C. § 194 (2000).

²⁵ I.R.C. § 48(b) (2000).

²⁶ I.R.C. § 631 (2000).

²⁷ I.R.C. § 126(a) (2000).

²⁸ C. Timothy Lindstrom, *The Tax Benefits of Conservation Easements*, 79 MICH. B. J. 690 (2000) (setting forth an example in which the donor receives a tax benefit equal to 146% of the cost of her easement).

II. TAX BENEFITS FOR FOREST LANDOWNERS

A. Reforestation Expenditures

The financial pressure on private landowners to deforest and develop forest land is growing.²⁹ The government has been assisting landowners for decades in resisting this pressure by enacting regeneration legislation.³⁰ One critical goal of forest management is “the promotion of forest regeneration for sustained timber production.”³¹ One of the common tools government uses to promote forestation and reforestation is tax incentives.³² Tax incentives have proven to be an efficient means of encouraging private forest owners in the expansion and maintenance of their forest lands.³³ To expand and maintain healthy forests, landowners expend forestation and reforestation costs over a prolonged time period. These costs may be incurred for years before landowners receive any economic benefit.

1. Amortization of Reforestation Expenditures

Under the Internal Revenue Code (the “Tax Code”), reforestation costs were required to be capitalized and recovered through depletion allowances.³⁴ A forest landowner received no current tax benefit for reforestation costs incurred during the year. The landowner increased her tax basis in her trees by all reforestation costs and recovered such costs as depletion only when she sold her timber.³⁵ In 1980, Congress enacted a provision to encourage forestation and reforestation by providing that up to \$10,000 per year (\$5,000 for married filing separate taxpayers) of qualifying reforestation expenditures may be amortized and deducted against ordinary income.³⁶ Qualifying taxpayers³⁷ with qualifying timber prop-

²⁹ See Beliveau, *supra* note 20, at 508 (stating that the greatest threats to the Northern Forest are widespread development and abusive forestry practices).

³⁰ See, e.g., Clarke-McNary Act, ch. 348, 43 Stat. 653 (1924) 16 U.S.C. 567 (former 16 U.S.C.S. § 567). The Clarke-McNary Act authorized the Secretary of Agriculture to provide federal cost-sharing for the provision of forest-tree seeds and plants. For further discussion of government forest regeneration legislation, see Lundmark, *supra* note 2, at 794 n.79.

³¹ Lundmark, *supra* note 2, at 786.

³² *Id.* at 797–802.

³³ *Id.*

³⁴ I.R.C. § 611 (2000); Treas. Reg. § 1.611-3(a) (2002).

³⁵ Treas. Reg. § 1.611-3(b) (2002) (setting forth calculation of depletion unit cost to determine the cost of timber sold and the corresponding depletion deduction for the tax year).

³⁶ Congress enacted I.R.C. § 194 as part of the Recreational Boating Safety and Facilities Improvement Act of 1980, Pub. L. No. 96-451, § 301(a), 94 Stat. 1983, 1989-91 (1980), 26 U.S.C. 194, 1980-2 C.B. 485.

³⁷ Qualifying taxpayers include individuals, S and C corporations, partnerships, and estates, but not trusts. I.R.C. § 194(b) (2000); Treas. Reg. § 1.194-1(a) (2002). Corporate taxpayers that are members of a controlled group must allocate the \$10,000 limitation among the members of that group. I.R.C. § 194(b)(2)(A). Partnerships and S corporations apply the \$10,000 limit at the partnership or corporate level and each partner or shareholder must

erty³⁸ may elect this provision in lieu of capitalizing reforestation expenses on a year-by-year basis.³⁹

Qualifying reforestation expenditures include the direct costs incurred for forestation or reforestation by planting or by artificial or natural seeding—including all costs incurred for site preparation, seeds or seedlings, and labor and tools.⁴⁰ Qualifying reforestation expenditures on qualifying timber property may be amortized and deducted over seven years.⁴¹ Irrespective of when forest owners incur reforestation costs during the year, the Tax Code provides one-half of one year's amortization in the first and last years of the amortization period and one full year of amortization in years two through seven.⁴² In the case of an individual taxpayer, the amortization deduction is classified as a taxpayer-favorable deduction to determine adjusted gross income rather than as a potentially less favorable itemized deduction.⁴³

Taxpayers must incur the reforestation expenditures with respect to qualifying timber property.⁴⁴ According to the Tax Code, qualifying tim-

apply the \$10,000 limit again at the individual taxpayer level. I.R.C. § 194(b)(2)(B); Treas. Reg. § 1.194-2(b)(5)–(6).

³⁸ See I.R.C. § 194(a), (c)(1). Qualifying timber property includes any woodlot or other site that “contain[s] trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for and cutting of trees for sale or use in the commercial production of timber products.” I.R.C. § 194(c)(1).

³⁹ See Treas. Reg. § 1.194-4(a) (describing the time and manner of making the election); see also Treas. Reg. § 1.194-4(c) (describing the provisions for requesting consent to revoke an election).

⁴⁰ I.R.C. § 194(c)(3)(A). Qualifying reforestation expenditures do not include taxpayer costs that the government has reimbursed under cost-sharing if these reimbursements are not included in gross income. See *infra* Part C. I.R.C. §§ 194(c)(3)(B), 126(a) (2000). If included in gross income, a taxpayer may include such costs. I.R.C. § 194. This latter approach is not taxpayer-favorable because the full amount of the reimbursement would be included in gross income in the year received and only a portion of the amount would be allowed as an offsetting deduction. To the extent provided under the Tax Code, taxpayers should not include cost-sharing reimbursements in gross income unless they are subject currently to low marginal income tax rates (e.g., current taxable income is zero or very low) and expect to be subject to relatively higher marginal income tax rates in the future (e.g., future taxable income will be higher).

⁴¹ I.R.C. § 194(a).

⁴² Treas. Reg. § 1.194-1(b) requires a half-year convention to be used for amortization purposes. As a result, a taxpayer will be allowed a half-year (6/84, i.e., six months out of the eighty-four months present in the seven-year amortization period) of amortization deductions for the tax year in which the reforestation expenditures are incurred, regardless of the month the expenditures were incurred. Thus, “[t]he maximum deduction in the first and eighth taxable years of the amortization period is . . . \$714.29.” (\$10,000/84 x 6 months). Treas. Reg. § 1.194-2(b)(1) (2002). The maximum deduction in each of the second through seventh taxable years is \$1,428.57 (\$10,000/7). Treas. Reg. § 1.194-2(b)(1) (2002).

⁴³ Deductions such as the reforestation amortization deduction reduce adjusted gross income, which can result in taxpayer-favorable results such as: increased personal and dependency deductions, I.R.C. § 151(d)(3) (2000); lesser amount of social security benefits included in gross income, I.R.C. § 86 (2000); and greater allowable itemized deductions (e.g., medical, I.R.C. § 213(a) (2000), casualty and theft loss, I.R.C. § 165 (2000), miscellaneous itemized deductions, I.R.C. § 67 (2000); and smaller cutback of itemized deductions I.R.C. § 68 (2000), etc.).

⁴⁴ I.R.C. § 194(a) (2000).

ber property includes any woodlot or other site that "contain[s] trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for and cutting of trees for sale or use in the commercial production of timber products."⁴⁵ While this definition may appear to be describing a significant commercial operation not in the purview of many private forest owners, the Treasury Regulations clarify the requirement as a minimum of one acre "planted with tree seedlings in the manner normally used in forestation and reforestation."⁴⁶ However, Congress did not intend that the amortization election would apply in a situation where a taxpayer plants a few trees on her personal residential property.⁴⁷ A taxpayer who incurs qualifying reforestation expenditures as a life tenant of the timber property can make the amortization election.⁴⁸

If a taxpayer sells the timber property within ten years of electing to amortize and deduct reforestation expenditures, any gain up to the amount of the amortization deductions must be characterized as ordinary income.⁴⁹ Ordinary income is generally subject to higher marginal income tax rates than long-term capital gains.⁵⁰ This provision is onerous because the taxpayer has to recapture all (and not a percentage) of her amortization deductions if she sells the timber property at any time before ten taxable years after the tax year in which the taxpayer incurred the reforestation expenses.⁵¹

For example, a taxpayer electing to amortize and deduct reforestation expenditures in 2002 would have to wait until 2013 to dispose of her property to avoid any ordinary income characterization. Ordinary income is currently subject to maximum marginal income tax rates of 38.6%, while long-term capital gain is subject to a maximum income tax rate of 20%.⁵² Therefore, the recapture of the amortization deductions as ordinary income significantly increases the tax rate on the gain attributable to

⁴⁵ I.R.C. § 194(c)(1).

⁴⁶ Treas. Reg. § 1.194-3(a).

⁴⁷ See Committee Report for Recreational Boating Safety and Facilities Improvement Act of 1980, Pub. L. No. 96-451, 1980-2 C.B. 485, 489.

⁴⁸ *Id.*; I.R.C. § 194(d).

⁴⁹ I.R.C. § 1245(b)(8) (2000); Treas. Reg. § 1.194-1(c).

⁵⁰ *Cf.* I.R.C. § 1(i) (West Supp. 2003) (setting forth marginal income tax rates of up to 38.6% for 2003) *to* I.R.C. § 1(h) (West Supp. 2003) (maximum long-term capital gain tax rate of 20%).

⁵¹ Treas. Reg. § 1.1245-4(h) (2002). For example, Ariel owns qualified timber property with a basis of \$30,000. In 1991, Ariel incurs \$12,000 of qualifying reforestation expenditures and elects to amortize the maximum \$10,000 under I.R.C. § 194. The \$10,000 is amortized and deducted from 1991 through 1998. If Ariel sells the property in 2000 for \$60,000, she must recognize a gain of \$28,000 (\$60,000 minus the adjusted basis of \$32,000). Because the sale occurred within ten years of the taxable year in which Ariel incurred the reforestation expenses, \$10,000 of gain must be characterized as ordinary income, and the remaining \$18,000 of gain would be characterized as capital gain (if it otherwise qualifies). To avoid any ordinary income treatment of gain attributable to the reforestation expenses incurred in 1991, Ariel would have to wait until 2002 to dispose of the property. *Id.*

⁵² I.R.C. § 1(h), (i) (West Supp. 2003).

the deductions. However, the taxpayer enjoyed the tax benefits of an ordinary income tax deduction for adjusted gross income during the preceding eight years she amortized up to \$10,000 of reforestation expenditures, which directly reduced her taxable income and decreased her ordinary income tax liability by approximately \$3500.⁵³ Taxpayers desiring to minimize overall tax costs want to generate reforestation deductions that will reduce their ordinary income and capital gains versus ordinary income by selling trees after any recapture of these deductions as ordinary income.

2. Reforestation Tax Credit

In addition to the tax benefits provided by the Tax Code for amortizing reforestation expenditures, the Tax Code allows an annual tax credit of up to ten percent of qualifying reforestation expenditures.⁵⁴ A tax credit is a dollar-for-dollar reduction of a taxpayer's tax liability.⁵⁵ Therefore, for the maximum annual qualifying reforestation expenditure of \$10,000, the ten percent reforestation tax credit provides up to \$1000 of annual tax savings. Taxpayers must reduce the amount of reforestation expenditures qualifying for amortization by fifty percent of the amount of the reforestation tax credit.⁵⁶ For example, if a taxpayer qualifies for and elects to take the maximum tax credit of \$1,000, she must reduce her amortizable reforestation expenditures by \$500 to \$9,500 (assuming the \$10,000 maximum). Assuming the taxpayer is subject to the thirty-five percent marginal income tax rate, her maximum tax benefits would be \$1,000 for the reforestation tax credit (received for the year the costs are incurred) and \$3,325⁵⁷ for the amortization deduction (received over the

⁵³ Assuming a 35% tax rate for the entire period (the ordinary income tax rates are scheduled to decrease to 35% in 2006 and thereafter). I.R.C. § 1(i) (West Supp. 2003). Section 901 of EGTRRA provides that all provisions in title V do not apply to taxable years beginning after December 31, 2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38. However, President Bush has recently proposed that Congress accelerate these tax rate reductions to 2003. See President Bush, Federal News Service, Full Text of President Bush's Remarks (to Economic Club of Chicago Unveiling Economic Stimulus Package) (Jan. 8, 2003), available at <http://www.nytimes.com/2003/01/08/politics/08BUSH-TEXT.html> (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review). There may be passive loss limitations on the amount of losses, including amortization deductions that a taxpayer may deduct currently. These limitations are based upon the facts and circumstances of each taxpayer and are not discussed herein. For a detailed discussion of the passive loss limitations, see James E. Williamson, *Timber Taxation*, 42 OIL & GAS TAX Q. 501, 504 (1994).

⁵⁴ I.R.C. § 48(b) (2000).

⁵⁵ A tax credit provides a more favorable dollar-for-dollar tax benefit than a tax deduction, which merely reduces taxable income. The actual tax benefit provided by a tax deduction is equal to the taxpayer's marginal tax rate multiplied by the amount by which the taxpayer's taxable income is reduced. See WILLIAM H. HOFFMAN ET AL. EDS., WEST FEDERAL TAXATION, INDIVIDUAL INCOME TAXES, 2003 EDITION (2003) at 3-19.

⁵⁶ I.R.C. § 50(c)(3)(A) (2000).

⁵⁷ \$9,500 amortizable reforestation expenditures multiplied by 35% marginal income tax rate.

amortization period), with a combined federal income tax savings of \$4,325 for \$10,000 of reforestation expenditures.

The reforestation tax credit is a nonrefundable credit.⁵⁸ Therefore, if a taxpayer does not have sufficient tax liability to offset with the credit, she will not receive any benefit for credit in excess of her tax liability. However, the credit can be carried back to offset any taxes in the immediately prior tax year and carried forward to apply to each of the subsequent twenty tax years.⁵⁹

The reforestation tax credit is subject to recapture (that is, repayment of the tax benefits received) if the qualifying timber property is disposed of within five tax years.⁶⁰ The Tax Code provides that the amount of the recapture of the tax credit is 100% if the property is disposed of within one full year.⁶¹ For each full year the property is held, the amount of the tax credit recapture is decreased by twenty percent until there is no recapture.⁶² If the taxpayer holds the timber property for five full years after she incurs the reforestation expenditures, she will not be required to recapture any amount of her reforestation tax credit. However, if the taxpayer disposes of the property before ten tax years after the tax year she incurred the expenses, she will be required to recapture as ordinary income any reforestation amortization deducted to the extent she recognizes any gain on the disposition.

If the taxpayer holds her timber property beyond the statutory recapture periods, the reforestation tax credit and the amortization deductions can provide noteworthy annual tax benefits and targeted incentives for reforestation, particularly for smaller investors and timber owners.⁶³

B. Qualifying Timber Activities for Preferential Long-Term Capital Gain and Ordinary Loss Treatment

Before Congress enacted the predecessor to Tax Code Section 631 in 1944, forest landowners who cut their timber to sell it or use it in their trade or business had to recognize any resulting income as ordinary income subject to ordinary income tax rates.⁶⁴ However, if a forest landowner held her trees as capital assets (e.g., for investment purposes) rather than as inventory (e.g., goods for sale in the ordinary course of business), any gain recognized from the sale of the trees would be eligible for tax-

⁵⁸ I.R.C. §§ 38(a), (c), 48(b), 46 (2000).

⁵⁹ I.R.C. § 39(a) (2000).

⁶⁰ I.R.C. § 50(a)(1) (2000).

⁶¹ I.R.C. § 50(a)(1)(B).

⁶² I.R.C. § 50(a)(1)(B).

⁶³ See William R. Singleton, *Significant Features of Timber Taxation*, 34 OIL & GAS TAX Q. 101, 126 (1985); see also Ron Singleton & James J. Jurinski, *The Effects of Tax Policies on Forestry Practices*, 40 OIL & GAS TAX Q. 763 (1992).

⁶⁴ See S. Rep. No. 627, 78th Cong., 1st Sess. (1943), 1944 C.B. 973, 993.

favored long-term capital gain treatment.⁶⁵ To qualify for this preferential tax treatment, forest landowners were motivated to have infrequent, unsolicited bulk sales of standing timber (e.g., capital assets) versus regular, solicited sales of small lots of routinely cut timber (e.g., inventory).⁶⁶ This method of income taxation created an incentive to sell large, bulk sales of standing timber (e.g., clear cutting).⁶⁷ Tax incentives for clear cutting are antithetical to forest management goals of managing timber as a renewable resource.⁶⁸ To remedy this incongruous treatment, Congress overrode a presidential veto and enacted the predecessor to Section 631 of the Tax Code in 1944.⁶⁹ Tax Code Section 631 allows forest landowners to qualify for tax-favored long-term capital gain tax rates whether or not they hold their trees as inventory or capital assets.⁷⁰

1. Election To Treat Cutting of Timber As Sale or Exchange: Tax Code Section 631(a)

Under the Tax Code, income is not recognized generally unless a taxpayer engages in a realization event (e.g., sale or exchange).⁷¹ Income from timber is not recognized until a taxpayer sells the timber or sells a timber product. Under the current Tax Code, the type of income recognized would be ordinary income or capital gain depending upon whether or not the timber is held as property primarily for sale to customers in the ordinary course of trade or business (e.g., inventory) or as a capital asset (e.g., an investment).⁷² Case law has defined the predominant tests for this determination.⁷³ If timber sales are frequent and development and

⁶⁵ I.R.C. § 50(a)(1)(A) (2000).

⁶⁶ See *infra* note 72.

⁶⁷ See Singleton, *supra* note 63, at 102 (noting that this method of taxation “created a bias to sell standing timber rather than managing timber as a renewable resource and provided little economic incentive for reinvestment (reforestation)”).

⁶⁸ See WIS. DEP’T OF NAT. RESOURCES, *supra* note 7, at 42 (describing clear cutting as inconsistent with “sustainable forestry,” which is defined in Wisconsin Statutes ch. 28.04(1)(e) as “[t]he practice of managing dynamic forest ecosystems to provide ecological, economic, social, and cultural benefits for present and future generations.” *Id.* at 15.

⁶⁹ Singleton, *supra* note 63, at 102.

⁷⁰ I.R.C. § 631 (2000). The predecessor to Section 631 is Section 117(k) enacted in 1944 as part of the Revenue Act of 1943, Pub. L. No. 78-235, 58 Stat. 21, 46–47 (1944), 26 U.S.C. § 117(k).

⁷¹ See *Eisner v. Macomber*, 252 U.S. 189 (1920) (noting that under the Sixteenth Amendment to the Constitution “income” subject to tax may be defined as gain derived from capital, provided that a sale or conversion of the property had occurred); *Helvering v. Bruun*, 309 U.S. 461, 469 (1940) (stating that gain may arise as a result of the exchange of property or other profit realized from a completed transaction).

⁷² See I.R.C. § 1221(a)(1) (2000).

⁷³ See *Broadhead v. Comm’n*, 25 T.C.M. 133 (1966), *aff’d*, 391 F.2d 841 (5th Cir. 1968) (noting that while taxpayers’ timber land sales were quite valuable, they were infrequent and, thus, not sales of inventory); *Kirby Lumber Corp. v. Scofield*, 89 F. Supp. 102 (W.D. Tex. 1950) (holding that property sold was held for investment rather than as inventory because of factors such as lack of frequent and continual sales, or lack of any regular sales promotion activities); *Scott v. United States*, 305 F.2d 460 (Ct. Cl. 1962) (determin-

sales activity is extensive, then the timber will likely be characterized as inventory, and any income from timber sales will be ordinary income instead of capital gain.⁷⁴ Conversely, if timber and forest land sales are infrequent and unsolicited and the forest property has not been extensively improved or developed, the forest landowner has a strong argument for characterizing this timber as an investment and any income realized from this timber as capital gain.⁷⁵

The risk of ordinary income characterization can be avoided completely if the taxpayer elects to treat her cutting of qualifying timber⁷⁶ as a sale or exchange of the timber under Section 631(a) of the Tax Code.⁷⁷ Under this provision, the taxpayer must cut her timber and have owned it for more than one year before the harvest.⁷⁸ However, the character of the timber as inventory or as an investment is irrelevant.⁷⁹ Any gain recognized will be characterized as long-term capital gain, and any loss recognized will be characterized as ordinary loss.⁸⁰ However, the election accelerates the recognition of gain or loss from the year the timber is sold to the year the timber is cut. The taxpayer must recognize gain or loss equal to the difference between the fair market value of the timber as of the first day of the tax year in which the timber is cut and the adjusted basis of the timber.⁸¹ Since there is no actual sale, the sale proceeds from

ing that large bulk sales of timber and timber land were not sales of inventory because company policy was to avoid such activities by not advertising or soliciting them and revenues from such activities were relatively small compared to core business of manufacturing and selling timber).

⁷⁴ See cases cited *supra* note 73.

⁷⁵ *Id.*

⁷⁶ Qualifying timber is timber that a taxpayer has owned or has held a contract right to cut for a period of more than one year. In this context, a "contract right to cut timber" means a right to sell the timber cut under the contract on her account or to use such cut timber in her trade or business. Treas. Reg. § 1.631-1(b)(1) (2002). The term "timber" includes evergreen trees (pine, spruce, fir, hemlock, cedar, and other coniferous trees), which are more than six years old at the time of severing from their roots (i.e., does not include live trees) and "are sold for ornamental purposes, such as Christmas decorations." Treas. Reg. § 1.631-1(b)(2).

⁷⁷ I.R.C. § 631(a) (2000).

⁷⁸ I.R.C. § 631(a); see *Varn, Inc. v. United States*, 425 F.2d 1231, 1237 (1970) (noting that where taxpayer did not cut her own timber Section 631(a) did not apply).

⁷⁹ Treas. Reg. § 1.631-1(b)(1).

⁸⁰ Treas. Reg. § 1.631-1(d)(4) (setting forth that the gain or loss recognized will be characterized as I.R.C. § 1231 property regardless of the actual character of the timber cut). Any gain recognized from the sale or exchange of Section 1231 property is generally characterized as tax-favored long-term capital gains (subject to maximum twenty percent tax rate) and any losses are generally recognized as tax-favored ordinary losses (providing tax benefits of up to 38.6% in 2002 and 2003). I.R.C. §§ 1(i), (h), 1231(a) (West Supp. 2003).

⁸¹ The taxpayer determines the adjusted basis of the timber by calculating depletion using the cost method. Treas. Reg. § 1.631-1(d)(1). The cost depletion method requires dividing the total tax basis of the forest by the estimated number of units to determine the per unit depletion amount. The unit depletion amount is multiplied by the number of units sold during the year to determine the cost depletion deduction for the tax year. Treas. Reg. § 1.611-3(b) (2002).

the deemed sale are deemed to be equal to the fair market value of the timber on the first day of the tax year in which the taxpayer cuts her timber.⁸² The taxpayer must determine the fair market value subjectively based upon all relevant facts and circumstances.⁸³ Because the taxpayer recognizes all of the built-in gain in the cut timber through the deemed sale, the cut timber, which is still held by the taxpayer and not actually sold, receives a tax basis equal to its fair market value on the first day of the tax year. Therefore, when the taxpayer actually sells her cut timber she will recognize gain, if any, only to the extent the actual sale proceeds exceed the deemed sale proceeds.⁸⁴ The general rules of income characterization determine whether any recognized gain will be capital gain or ordinary income (i.e., as capital gain if the timber was held as an investment and ordinary income if the timber was held as inventory).⁸⁵

If a forest landowner makes the Section 631(a) election, it is binding on her for all timber owned or for all timber she has the right to cut for the tax year of the election and for all subsequent tax years.⁸⁶ The taxpayer can only revoke the election upon a showing of undue hardship and with permission of the Commissioner of the Internal Revenue Service.⁸⁷ If a taxpayer receives permission to revoke an election, she is precluded from making a new election unless the Commissioner affirmatively consents to a reelection. Therefore, the election is permanent and should be made with careful consideration of the short-term and long-term consequences.

The primary advantage of the Section 631(a) election is that all of the built-in gain as of the first day of the tax year in which the taxpayer cuts her timber will be characterized as tax-rate-favored long-term capital gain instead of ordinary income. Any losses recognized will be characterized as tax-favored ordinary losses versus significantly limited⁸⁸ capital

⁸² Treas. Reg. § 1.631-1(d)(3) (2002).

⁸³ Treas. Reg. § 1.631-1(d)(2). Due to the subjectivity and critical aspect of fair market value in this determination, the Internal Revenue Service has opposed taxpayers' alleged fair market values in numerous Section 631(a) cases. *Hudspeth v. Comm'n*, 914 F.2d 1207, 1209-10 (9th Cir. 1990), *aff'g in part and rev'g in part on other grounds and remand'g* 51 T.C.M. 175 (1985) (setting forth extended Tax Court and appellate court battles over fair market value of cut timber for Section 631(a) election); *Emerson v. Comm'n*, 44 T.C. 86 (1965) (determining taxpayer's fair market value of cut timber for Section 631(a) election was overstated); *Camp v. United States*, 74-2 U.S.T.C. P9596 (M.D. Fla. 1974) (determining fair market value of cut timber for Section 631(a) election based upon expert testimony); *Bratton v. Rountree*, 76-1 U.S.T.C. P9198 (M.D. Tenn. 1976) (finding partnership erred in its computation of fair market value of cut timber for Section 631(a) election).

⁸⁴ The gain recognized, if any, would be equal to the actual sale proceeds received less the new adjusted basis in the cut timber, which is equal to the fair market value of the timber on the first day of the tax year in which the taxpayer cuts her timber. *See* I.R.C. § 1001 (2000); Treas. Reg. § 1.631-1(d)(3).

⁸⁵ *See* discussion *supra* notes 71-75 and accompanying text.

⁸⁶ I.R.C. § 631(a) (2000).

⁸⁷ I.R.C. § 631(a) (2000); Treas. Reg. § 1.631-1(a)(3)-(4).

⁸⁸ For individual taxpayers, capital losses are limited to offset capital gains plus \$3,000 per tax year (\$1,500 for married filing separate taxpayers). I.R.C. § 1211(b) (2000).

losses.⁸⁹ Additionally, the forest landowner can manage the timing of her cutting and the subsequent sale of the cut timber to spread any gain recognized over several tax years.⁹⁰ This flexibility allows a taxpayer to time her capital gain and ordinary loss recognition. As a result, she can avoid bunching of income and higher marginal tax rates for any one tax year.⁹¹ Moreover, the taxpayer can optimize other tax benefits such as maximizing capital loss offsets by generating capital gains during or after tax years in which she recognized capital losses.⁹² For instance, taxpayers that have significant built-in capital losses and that have capital loss “carryforwards” from failed stock market investments can use their capital losses to offset future (but not past) capital gains. The flexibility to select the tax year for recognizing income and losses can provide meaningful tax planning opportunities for forest landowners.⁹³

However, there are potential disadvantages of Section 631(a) elections that under certain circumstances may undermine the advantages. Elections under Section 631(a) require cash management planning. The election accelerates gain recognition to the year of cutting versus the year of sale. Therefore, the taxpayer should be aware that there could be tax due on the deemed sale before any cash sale proceeds are received to pay the tax liability. However, because taxes may not be due on the deemed sale until April 15 of the following tax year, the taxpayer may receive her sale proceeds in time to pay her tax liability.⁹⁴ If the taxpayer has to borrow funds to pay her accelerated tax liability, the borrowing costs could offset any tax savings. Moreover, if the price of the cut timber is volatile, its actual sale could generate cash flow that is significantly less than the

⁸⁹ Treas. Reg. § 1.631-1(d)(4) (setting forth that any gain or loss is characterized as gain or loss from the sale or exchange of Section 1231 property).

⁹⁰ The actual sale of the timber may generate a gain if the taxpayer sells her timber for an amount in excess of its fair market value on the first day of the tax year. This sale could be made in the subsequent tax year to spread income recognition over two tax years and minimize overall tax costs.

⁹¹ See I.R.C. §§ 1 (setting forth progressive individual income tax rates), 68 (setting forth cutback on itemized deductions for taxpayers with adjusted gross incomes over a threshold level), 151(d)(3) (setting forth phase-out of personal exemptions for taxpayers with adjusted gross incomes over a threshold amount) (2000).

⁹² For individual taxpayers, capital losses are first offset against capital gains and then up to \$3,000 per tax year are offset against ordinary income. While capital losses may be carried forward indefinitely, they may not be carried back. I.R.C. §§ 1211(b), 1212(b) (2000). As a result, taxpayers recognizing significant capital losses in tax years after they recognized significant capital gains lose the tax benefit of any offset of the loss against the gain. The ability to time recognition of capital gains may provide a taxpayer with the ability to maximize any tax benefit from capital losses. See also James E. Williamson, *Timber Taxation: Twenty Percent Tax Rate Makes Timber More Attractive*, 48 OIL, GAS & ENERGY Q. 251, 267 (1999) (noting that timber owners can achieve better overall financial results by controlling the timing of any gain or loss recognition to maximize favorable tax consequences).

⁹³ See Williamson, *supra* note 92, at 252.

⁹⁴ Taxpayers may be required to pay increased estimated tax payments during the year of the deemed sale to avoid underpayment penalties. I.R.C. § 6651 (2000).

deemed sale proceeds and in extreme cases less than the accelerated tax liability. If the taxpayer anticipates a long delay between the cutting and the actual sale of the timber or the possibility that a sale may never occur (e.g., no demand or readily damaged product), she may not want to make the election and prepay the tax even at reduced tax rates. Forest landowners must carefully consider these disadvantages and any advantages in the short-term and long-term before they make this binding election.

2. Timber Sold with a Retained Economic Interest Characterized As Section 1231 Property: Tax Code Section 631(b)

Section 631(a) does not apply to many forest landowners because they do not cut their own timber. These forest landowners contract with loggers who agree to cut their timber.⁹⁵ If the timber sold was inventory held for sale to customers in the ordinary course of business, or if the payments are considered rent from the timber property, the timber income will be characterized as ordinary income instead of tax-favored long-term capital gain.⁹⁶ Section 631(a) does not provide relief for these forest landowners, but Section 631(b) treats any gain or loss recognized from timber sold with a retained economic interest as long-term capital gain or ordinary loss regardless of the actual characterization of the timber as inventory or the payments as rent.⁹⁷

To qualify for this tax-favored treatment, the taxpayer must sell her timber and retain an “economic interest” in her property.⁹⁸ To satisfy this requirement, the taxpayer must possess, through any legal relationship, an investment in standing timber from which she receives income as a return on her investment.⁹⁹ The income received must be derived from the sale of severed timber and depends upon the amount of timber cut.¹⁰⁰ Moreover, the taxpayer must transfer the right and the obligation to cut, take title to, and pay for the severed timber pursuant to contract terms.¹⁰¹

⁹⁵ Williamson, *supra* note 53, at 510 (noting that because so much of U.S. forests are held in small parcels, the timber products industry is well adapted to log and buy timber from small tracts).

⁹⁶ Ron Singleton & James J. Jurinski, *The Effects of Tax Policies on Forestry Practices*, 40 OIL & GAS TAX Q. 763, 775 (1992).

⁹⁷ Treas. Reg. § 1.631-2(a)(2) (2002) (applying the provisions of Section 1231 to any gains or losses recognized under Section 631(b)).

⁹⁸ I.R.C. § 631(b) (2000); *see* Treas. Reg. § 1.611-1(b)(1) (2002).

⁹⁹ Treas. Reg. § 1.611-1(b)(1) (2002).

¹⁰⁰ Treas. Reg. § 1.611-1(b)(1) (2002); *see* Dyal v. United States, 342 F.2d 248, 252 (5th Cir. 1965) (finding that taxpayer did not retain an economic interest where payments were not based upon amount of timber cut); Crosby v. United States, 414 F.2d 822, 825 (5th Cir. 1969) (holding that taxpayer did not retain an economic interest where payments were not contingent on severance of timber); Plant v. United States, 682 F.2d 914, 917 (11th Cir. 1982) (holding that taxpayer did not retain an economic interest because contract payments were not based upon actual severance of timber).

¹⁰¹ I.R.C. § 631(a) (2000).

Under Section 631(b), the taxpayer must recognize gain or loss equal to the amount realized from the sale of the timber less the adjusted basis of the timber.¹⁰² However, any payments received pursuant to an expired, abandoned, or terminated contract under which no trees were cut must be characterized as ordinary income without any basis offset.¹⁰³ Similar to Section 631(a), the forest landowner¹⁰⁴ must have owned the timber¹⁰⁵ for more than one year prior to its sale to qualify for this favorable treatment.¹⁰⁶ Under this provision, the date of sale of the timber is the date the timber is cut.¹⁰⁷

If the taxpayer receives an advance payment, the taxpayer may elect to treat the date of the payment—rather than the later date of cutting—as the date of sale.¹⁰⁸ This election could be used to ensure the timing of the timber sale when weather or other factors may delay the cutting until after the end of the tax year.¹⁰⁹ The election can set the tax year that the sale will occur irrespective of when the loggers actually cut the timber.

Alternatively, under certain circumstances a taxpayer could use the election to avoid Section 631(b) treatment. Because Section 631(b) is mandatory rather than elective, it will automatically apply to sales of timber (with retained economic interests) held for more than one year. The only way to avoid Section 631(b) is to fail to satisfy its requirements.

If the date of the advance payment is within one year of the date the timber was acquired and the date of cutting would be more than one year after the timber was acquired, under unique circumstances forest owners may want to make this election to fall out of Section 631(b).¹¹⁰ Under these facts and without this election, Section 631(b) would apply because the timber would be held for more than one year as of the date of cutting.¹¹¹ With the election, Section 631(b) would not apply because the deemed sale date would be the date of the payment and the timber would

¹⁰² I.R.C. § 631(b) (2000).

¹⁰³ Treas. Reg. § 1.631-2(d) (2002).

¹⁰⁴ Treas. Reg. § 1.631-2(d) (2002). The provisions of Section 631(b) apply to a timber owner, including a sublessor and a holder of a contract to cut timber. A contract holder must have a right to cut timber for sale on her own account or for use in her trade or business to own an interest in timber within the meaning of Section 631(b). Treas. Reg. § 1.631-2(e)(2).

¹⁰⁵ For purposes of Section 631(b), the term “timber” includes evergreen trees, which are more than six years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. The term “evergreen trees” is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees. Treas. Reg. § 1.631-2(e)(3).

¹⁰⁶ I.R.C. § 631(b).

¹⁰⁷ The “date timber is cut” means the date when in the ordinary course of business the quantity of timber felled is first definitely determined. Treas. Reg. § 1.631-2(b)(2).

¹⁰⁸ Treas. Reg. § 1.631-2(b)(2).

¹⁰⁹ Williamson, *supra* note 92, at 268.

¹¹⁰ Treas. Reg. § 1.631-2(b)–(c).

¹¹¹ Treas. Reg. § 1.631-2(c).

not have been held for more than one year.¹¹² This election provides some flexibility to certain forest owners with facts that may not favor characterizing their timber gains or losses under Section 631(b). For example, if a taxpayer wants her timber income characterized as ordinary income rather than capital gain,¹¹³ or alternatively wants her timber losses characterized as capital losses rather than ordinary losses, she will want to fall outside of the mandatory provisions of Section 631(b).¹¹⁴ The election to treat the date of an advanced payment as the date of cutting can provide taxpayers with unique tax postures to structure their timber sales to fall out of Section 631(b) and receive preferable alternative tax treatment.

Most forest owners will want to structure their timber sales with retained economic interests to benefit from the favorable long-term capital gain and ordinary loss provisions provided under Section 631(b). The only requirement the forest landowner must meet to fall under this provision is that she must hold her timber for more than one year before the cutting begins. Forest landowners desiring to sell their timber through a “cutting contract” can negotiate the terms of the contract to ensure that cutting begins more than one year after the date they acquire the timber. Therefore, the tax benefits of Section 631(b) are readily available to forest landowners who contract the harvesting of their timber. Accordingly, forest landowners can sell their timber through qualifying “cutting contracts” and benefit from guaranteed tax-favored long-term capital gain or ordinary loss treatment irrespective of the character of the timber as inventory or the payments as rent.

¹¹² Treas. Reg. § 1.631-2(c).

¹¹³ For example, this may occur if a taxpayer has a net operating loss that is about to expire (I.R.C. § 172(b) (2000)) and has capital loss carryforwards, which can be carried forward indefinitely (I.R.C. § 1212(b) (2000)). The taxpayer may receive more financial benefit from characterizing the income as ordinary income and offsetting the income with the expiring net operating loss rather than the capital loss (indefinite) carryforward.

¹¹⁴ For example, assume that Zoe, a forest landowner, has significant capital losses from her sale of dot.bomb stock at prices well below cost. Zoe also has significant ordinary losses under Section 1231 of the Tax Code from her sale of business property at a significant loss. If Zoe sells her timber interest with a retained interest at a significant gain under the provisions of Section 631(b), her timber gain would be characterized as Section 1231 gain and would be offset against her Section 1231 losses. As a result, her Section 1231 ordinary losses would be reduced to zero and her capital losses from the sale of her dot.bomb stock would be limited to \$3,000 against her other income (including her salary). Now assume Section 631(b) does not apply because Zoe elected to treat the date of her advanced payment as the date of sale and the payment was received by Zoe within one year of the date she acquired her timber. Zoe may be able to characterize her timber income as capital gain if her forest land is held as an investment. This short-term capital gain would be offset against her dot.bomb capital losses and her significant Section 1231 ordinary losses could be offset without limitation against her other income (including her salary).

C. Government Reimbursements and Cost-Sharing Payments

Under a number of federal, state, and local programs, the government reimburses forest owners for all or some of their reforestation and forest maintenance costs.¹¹⁵ Under the Tax Code, a certain portion of the payments from certain government programs,¹¹⁶ including the forest incentives program,¹¹⁷ are excluded from a recipient's taxable income.¹¹⁸ The portion of qualifying payments excluded from gross income is the portion: (1) the Secretary of Agriculture determines is primarily for the purpose of improving forests or providing a habitat for wildlife, among other good acts; and (2) the Secretary of the Treasury determines does not increase substantially the annual income from the property.¹¹⁹ Under Temporary Treasury Regulations,¹²⁰ the excludable portion of any qualifying payment is defined as the "present fair market value of the right to receive annual income from the affected acreage of the greater of ten percent of the prior average annual income from the affected acreage or \$2.50 times the number of affected acres."¹²¹

The Tax Code provides that although forest landowners can exclude a certain portion of qualifying payments, they cannot receive a double tax benefit for such amounts. Any reforestation payments that are excluded from a taxpayer's taxable income cannot be deducted or included in any tax credit or the cost basis of the timber.¹²² Moreover, if property acquired, improved, or otherwise modified with excluded payments is disposed of within twenty years from the date of receipt of the payments, all or a portion of any gain realized must be recognized as ordinary income.¹²³ If a property owner transfers her property in certain tax-deferred

¹¹⁵ Lundmark, *supra* note 2, at 794–95 n.79 (describing the history of federal cost-sharing programs back to The Clarke-McNary Act of June 7, 1924); WIS. DEPT. OF NAT. RESOURCES, FOREST MANAGEMENT GUIDELINES, 227 available at <http://www.dnr.state.wi.us/org/land/forestry/private/FMG/090402appendicesLR.pdf> (stating that the Wisconsin Landowner Grant Program provides \$1,250,000 of cost-sharing annually for stewardship practices, including tree planting and forest improvements on private lands, and that DNR foresters will assist landowners in obtaining benefits from four federal cost-sharing programs including the Forest Land Enhancement Program and the Conservation Reserve Program) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

¹¹⁶ I.R.C. § 126(a)(1)–(10) (2000).

¹¹⁷ I.R.C. § 126(a)(8) (the forest incentives program authorized by Section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103)).

¹¹⁸ I.R.C. § 126(b)(1).

¹¹⁹ I.R.C. § 126(b)(1).

¹²⁰ Temporary Treasury Regulations have the same authority as general regulations until they expire three years after issuance. I.R.C. § 7805(e)(2) (2000).

¹²¹ Temp. Treas. Reg. § 16A.126-1(a) (2002) (issued in 1981, therefore well beyond its three year expiration date, nevertheless provides IRS guidance, but does not have the force and effect of law).

¹²² I.R.C. § 126(e) (2000).

¹²³ I.R.C. § 1255(a) (2000). The owner must hold the property for twenty years from the date she receives her payments to avoid any characterization of gain realized as ordi-

transactions¹²⁴ or through a lifetime or date of death gift, she will not have to recognize any excluded payments as income.¹²⁵ However, the potential for recapture of any excluded payments over the original twenty-year period remains with the property in the hands of the transferee.¹²⁶ If the property's tax basis in the hands of the transferee is its fair market value (e.g., the property was received from a decedent and its basis was raised to fair market value at the date of death), then any potential recapture of the excluded payments as ordinary income completely disappears.¹²⁷

A taxpayer can elect to include some or all of these otherwise excludable payments in income.¹²⁸ If the taxpayer makes this election, she must include the payments in her gross income, but will be able to deduct the payments, take a credit, or include the payments in the cost basis of her timber.¹²⁹ Moreover, under such election, the ordinary income recapture provisions discussed previously will not apply.¹³⁰

The Temporary Treasury Regulations set forth an example of how this provision can provide private forest landowners with an exclusion of government- provided reforestation costs from gross income:

In 1980, the taxpayer reforests 200 acres of nonindustrial private forest land by planting tree seedlings. The taxpayer pays the full cost of the reforestation, \$15,000. Under the cost-sharing provisions of the forestry incentives program, the taxpayer receives a reimbursement from USDA of \$12,000. The Secretary of Agriculture certifies that 100% of the USDA payment is primarily for the purpose of conservation. Assume that the excludable portion is \$3,500 and that based on all the facts and circumstances, the value of the improvement is \$15,000. The amount which is includible in income is the value of the section 126 improvement, reduced by the excludable portion and the taxpayer's share of the cost of the improvement. Therefore the taxpayer includes

nary income. If the owner disposes of the property in the first ten years of this twenty-year period, she must treat any gain realized as ordinary income to the extent of 100% of the excluded payments. If the owner disposes of the property during the next ten years, the amount of excluded income subject to recapture as ordinary income is reduced from 100% by 10% per year until after twenty years there is no recapture. *See also* Temp. Treas. Reg. § 16A.1255-1(a)(1) (1981) (setting forth that the recognition as ordinary income is limited to the lesser of (1) the excludable amount of the payment or (2) the amount of gain recognized less gain treated as ordinary income under other provisions of the Tax Code).

¹²⁴ For example, a tax-deferred real estate exchange under I.R.C. § 1031 (like kind exchange) or tax-deferred transfers under I.R.C. §§ 721, 351 (transfers to a partnership or controlled corporation). Temp. Treas. Reg. § 16A.1255-2(c) (1981).

¹²⁵ Temp. Treas. Reg. § 16A.1255-2 (1981).

¹²⁶ Temp. Treas. Reg. § 16A.1255-2(d).

¹²⁷ Temp. Treas. Reg. § 16A.1255-2(b)(2).

¹²⁸ I.R.C. § 126(c) (1981).

¹²⁹ I.R.C. § 126(d)-(e) (2000).

¹³⁰ I.R.C. § 126(c).

\$8,500 in gross income as a result of the USDA payment, computed as follows:

Value of section 126 improvement	\$15,000
(Excludable portion)	(3,500)
(Taxpayer's contribution)	(3,000) ¹³¹
Amount included in gross income	\$ 8,500 ¹³²

With this example, the forest landowner must include \$8,500 in gross income. The landowner will be allowed to either include the entire \$8,500 in her timber basis or, if the costs incurred are qualifying reforestation expenditures, elect to take a reforestation tax credit of \$850¹³³ and amortize \$8,075¹³⁴ of reforestation expenditures. If the forest landowner sells the timber attributable to the reimbursed reforestation costs before 1991, any gain realized up to \$3,500 would have to be characterized as ordinary income. For each year after 1991, the maximum amount of ordinary income recapture will be reduced by \$350.¹³⁵

Alternatively, the taxpayer could elect to include some or all of the reimbursed payments of \$12,000 in her gross income instead of \$8,500. If she does include the entire \$12,000 in her gross income, the taxpayer should be able to take a reforestation tax credit of \$1,000 and amortize \$9,500 of the reforestation expenditures.¹³⁶ The \$2,000 of reforestation expenditures above the \$10,000 annual limit should be capitalized to the basis of the timber.¹³⁷ If the forest landowner sells her timber after any applicable recapture period, all of the gain may be characterized as tax-favored long-term capital gain under the applicable Section 631(a) or (b).¹³⁸

Forest landowners who receive government reimbursements for reforestation and other forest maintenance costs will want to review their short- and long-term plans before they decide to exclude or elect to include some or all of these payments in gross income.¹³⁹ Although excluding the payments from gross income may appear initially to be the best financial decision, the economic analysis is multifaceted. Depending

¹³¹ Temp. Treas. Reg. § 16A.126-1(g) Example (5) (2002) (calculating the taxpayer's contribution as \$15,000 out of pocket costs minus \$12,000 reimbursements).

¹³² Temp. Treas. Reg. § 16A.126-1(g).

¹³³ $10\% \times \$8,500 = \850 . I.R.C. § 48(b) (2000). See *supra* note 55 and accompanying text.

¹³⁴ $\$8,500 - .5(\$850) = \$8,075$. I.R.C. § 194 (2000). See *supra* note 57 and accompanying text.

¹³⁵ See I.R.C. § 1255(a)(3) (2000).

¹³⁶ I.R.C. §§ 194, 48(b) (2000).

¹³⁷ I.R.C. §§ 126(e), 194(c)(3)(B), 1016 (2000).

¹³⁸ See *supra* Sections II.B.1-2.

¹³⁹ See I.R.C. § 126(c) (setting forth election out of exclusion); Temp. Treas. Reg. § 16A.126-2 (1981) (setting forth election is for all or any part of the excludable payments).

upon facts and circumstances, it may be more economical to: (1) include all (or a portion) of the payments in income; (2) elect to amortize qualifying reforestation expenditures; (3) take a dollar-for-dollar tax liability reduction in the reforestation tax credit; or (4) after ten years sell the timber through a "cutting contract" with a retained economic interest and receive favorable long-term capital gain treatment with zero recapture of the amortization or the tax credit.

The forest landowner's decision will depend upon her current and future tax profiles as well as her plans for the timber and the forest land. If she plans to hold the property until her death and her current marginal income tax rate is higher than it may be in the future, it may be more economical to exclude all of the payments from gross income. However, if she is currently in a very low marginal income tax bracket and will likely be in a much higher tax bracket during any recapture or amortization period, it may be more economical to include all of the payments in her current gross income and enjoy amortization deductions and avoid recapture during higher tax rate years. Forest landowners will want to project tax scenarios for at least the next decade to determine the best overall financial plan.

D. Conservation Easements

Conservation easements have become "the single most important tool to protect privately owned land across the nation."¹⁴⁰ More than 2.6 million acres of land are currently protected by conservation easements held by private land trusts.¹⁴¹ Government agencies have used easements as an environmental preservation tool since the 1930s, and their popularity has increased appreciably over the last decade.¹⁴²

Conservation easements offer attractive incentives and characteristics for forest landowners and environmentalists.¹⁴³ A conservation ease-

¹⁴⁰ Julie Ann Gustanski, *Protecting the Land: Conservation Easements, Voluntary Actions, and Private Lands*, in PROTECTING THE LAND: CONSERVATION EASEMENTS PAST, PRESENT, AND FUTURE 9, 9 (Julie Ann Gustanski & Roderick H. Squires, eds., 2000).

¹⁴¹ Acreage subject to conservation easements held by government agencies is not included in this estimate. See Katherine Q. Seelye, *More Families Adopting Lasting Limits to Preserve Land*, N.Y. TIMES, Sept. 12, 2001, at B1; Gustanski, *supra* note 140 at 9.

¹⁴² Laura S. Beliveau, *The Forest Legacy Program: Using Conservation Easements to Preserve the Northern Forest*, 20 B.C. ENVTL. AFF. L. REV. 507, 519 (1993). In 1990, Congress enacted the Forest Legacy Program to enable the federal government to purchase conservation easements to protect forest lands that are environmentally threatened by conversion to non-forest uses. Congress gives priority to forest lands that face conversion into residential, recreational, or industrial uses. The Forest "Legacy Program's goal is to encourage continued private ownership of forest lands and industrial owners' current commercial practices while preserving the environmental quality of the region." *Id.* at 514-19, 524-25.

¹⁴³ Jeffrey Tapick, *Threats to the Continued Existence of Conservation Easements*, 27 COLUM. J. ENVTL. L. 257, 259-60 (2002) (noting that "[c]onservation easements are created through voluntary, free market transactions between landowners and easement hold-

ment is a freely negotiated voluntary agreement a landowner makes to restrict the development of her property.¹⁴⁴ Easements are legal contracts negotiated to benefit individual landowners and easement holders.¹⁴⁵ Landowners can “retain the right to subdivide, fish, even reserve timber rights or allow the construction of an additional home.”¹⁴⁶ Although conservation easements offer landowners extreme flexibility, they generally are structured within the constraints of government regulatory provisions to maximize income, estate, and property tax benefits. The income, estate, and property tax benefits a forest landowner can derive from a conservation easement can equal or exceed the cost (the reduction in land value due to the imposition of the easement)¹⁴⁷ of the easement.¹⁴⁸

1. Income Tax Benefits

In 1964, the Internal Revenue Service ruled that a taxpayer’s contribution of a restrictive easement on his scenic forest land qualified as a deductible charitable donation.¹⁴⁹ Since then, Congress has expanded and

ers”).

¹⁴⁴ *Id.*

¹⁴⁵ See *id.* at 264–68 (noting that the conservation easement is a relatively new land use concept and that William H. Whyte was the first land use lawyer to champion their use in 1959).

¹⁴⁶ Robert Lenzner, *Hard Assets: “Asphalt is Always the Last Crop”: Here’s a Nifty Way to Get a Big Tax Break and Protect Valuable Property: Grant a Conservation Easement*, FORBES, June 15, 1998, at 186, 187; see also West Wisconsin Land Trust, *Three Families & the Lake They Love*, 6 COMMON GROUND, Fall 2002, at 6 (describing three different conservation easements imposed on three different parcels on the same lake but owned by three different families); C. Timothy Lindstrom & Stephen J. Small, *New Estate Tax Relief for Land Under Conservation Easement*, 78 TAX NOTES 1171, 1172 (1998) (citing several private letter rulings in which taxpayers were allowed to continue timber harvesting and management, ranching, agriculture and equestrian activities under qualifying conservation easements).

¹⁴⁷ See Treas. Reg. § 1.170A-14(h)(3)(i) (2002) (providing that the value of the easement is its fair market value based upon a “comparable sales” appraisal process, but where comparable sales are not available (and generally they would not be) then the value of the easement is the difference in value of the land with and without the easement); see also Treas. Reg. § 1.170A-14(h)(3)(ii) (describing detailed provisions regarding the “before and after” method of valuation).

¹⁴⁸ A forest landowner can capture the current appreciation in market value by imposing a conservation easement that significantly diminishes the value of the property but allows her to retain ownership and enjoyment of the property. For an easement that reduces the value of the property by thirty percent, a donor in the 39.6% highest marginal federal income tax bracket and the fifty-five percent estate tax bracket can generate a federal tax savings equal to 145% of the cost of the easement. See C. Timothy Lindstrom, *The Tax Benefits of Conservation Easements*, 79 MICH. BAR J. 690, 690 (2000).

¹⁴⁹ See Rev. Rul. 64-205, 1964-2 C.B. 62 (allowing charitable deduction under Section 170 for scenic easement); Kingsbury Browne, Jr. & Walter G. Van Dorn, *Charitable Gifts of Partial Interests in Real Property for Conservation Purposes*, 29 TAX LAW. 69, 71 (citing I.R.S. News Release No. 784, Nov. 15, 1965 advertising availability of charitable donation deduction for contribution of scenic preservation easements); see also Jeffrey A. Blackie, *Conservation Easements and the Doctrine of Changed Circumstances*, 40 HASTINGS L.J. 1187, 1191 (1989).

codified these tax benefits to motivate landowners to place certain irrevocable restrictions on the commercial development or use of their property.¹⁵⁰ To qualify for the tax benefits, a conservation easement must satisfy numerous requirements that Congress has established to ensure that the easement will provide an enduring conservation purpose for the public good.¹⁵¹ Typical conservation easements qualifying for tax benefits protect farmland,¹⁵² ranch land,¹⁵³ wildlife habitat,¹⁵⁴ land possessing unusual beauty,¹⁵⁵ and forest land.¹⁵⁶

If a forest landowner voluntarily agrees to impose a qualified conservation easement on her land, the fair market value of her forest land will decrease. This decrease in land value is deemed a charitable contribution to the betterment of mankind.¹⁵⁷ The Tax Code recognizes this contribution and, if all the applicable requirements are satisfied, the landowners can deduct the easement as a charitable contribution.¹⁵⁸ To qualify for a charitable contribution deduction, an easement must satisfy the requirements for a "qualified conservation contribution."¹⁵⁹

a. Qualified Conservation Contribution

Generally, Congress has not permitted a charitable deduction for gifts of partial interests in property.¹⁶⁰ Congress imposed this restriction in 1969 to prohibit taxpayer abuse of gifts of partial property interests such as the "gift of rent-free use of property."¹⁶¹ One of the attributes of a conservation easement is that it is a partial interest in real property. A forest landowner can impose a conservation easement on her property and enjoy most of the benefits of land ownership.¹⁶² To encourage landowners to preserve their property, Congress enacted an exception for contribu-

¹⁵⁰ See generally Janet L. Madden, *Tax Incentives for Land Conservation: The Charitable Contribution Deduction for Gifts of Conservation Easements*, 11 B.C. ENVTL. AFF. L. REV. 105, 125-38 (1983).

¹⁵¹ See generally I.R.C. §§ 170(h) and 2031(c) (2000).

¹⁵² Priv. Ltr. Ruls. 87-110-54 (Dec. 15, 1986) and 87-130-16 (Dec. 23, 1986).

¹⁵³ Priv. Ltr. Rul. 87-210-17 (Feb. 17, 1987).

¹⁵⁴ Priv. Ltr. Ruls. 82-470-24 (Aug. 18, 1982), 90-520-28 (Sept. 28, 1990), and 93-180-17 (Feb. 3, 1993).

¹⁵⁵ Priv. Ltr. Rul. 86-520-13 (Sept. 24, 1986).

¹⁵⁶ Priv. Ltr. Rul. 95-370-18 (June 20, 1995).

¹⁵⁷ I.R.C. § 170(h).

¹⁵⁸ I.R.C. § 170(e)(1).

¹⁵⁹ I.R.C. § 170(h).

¹⁶⁰ I.R.C. § 170(f)(3)(A).

¹⁶¹ See Browne, Jr. & Van Dorn, *supra* note 149, at 74.

¹⁶² "Easements normally permit the continuation of the uses being enjoyed by the landowner at the time of the donation of the easement." Lindstrom & Small, *supra* note 146, at 1172. "[L]and subject to a conservation easement may be freely sold, donated, passed on to heirs, and transferred in every normal fashion, so long as the land remains subject to the restrictions of the easement." *Id.*

tions of certain partial interests that provides donors with a charitable deduction for their qualifying grants of conservation easements.¹⁶³

To be eligible for the deduction, the transfer of the conservation easement (a partial interest) must be a “qualified conservation contribution”¹⁶⁴ as defined in Tax Code Section 170(h). There are four basic requirements for a qualified conservation contribution: the property contributed must be a “qualified real property interest;”¹⁶⁵ the property must be donated to a “qualified organization;”¹⁶⁶ the gift must be for “conservation purposes;”¹⁶⁷ and the contribution must be “exclusively for conservation purposes.”¹⁶⁸

i. Qualified Real Property Interests

There are three categories of qualified real property interests.¹⁶⁹ The relevant category for conservation easements includes perpetual conservation restrictions or restrictions on the use of property granted in perpetuity.¹⁷⁰ Perpetual conservation restrictions include easements and restrictive covenants.¹⁷¹

For example, a taxpayer donates to a qualified donee a conservation easement that restricts in perpetuity improvement on 1000 acres of forest land to two single-family residences and ancillary buildings. This would constitute a perpetual conservation restriction. To ensure enforceability of such easements, any mortgagee with an existing mortgage on the protected property must subordinate its rights to the easement holder to enforce the conservation purposes of the gift in perpetuity.¹⁷²

ii. Qualified Organizations

Not all charitable organizations eligible to receive deductible charitable contributions are eligible to receive deductible qualified conservation contributions. Organizations qualified to hold a conservation easement are generally limited to federal, state, and local government agencies and public charities.¹⁷³ Qualified organizations must also have a commitment to protect

¹⁶³ See I.R.C. § 170(f)(3)(B)(iii) (setting forth that a “qualified conservation contribution” is one of three exceptions to the general rule that certain contributions of partial interests do not qualify for a charitable deduction).

¹⁶⁴ I.R.C. § 170(f)(3)(B)(iii).

¹⁶⁵ I.R.C. § 170(h)(1)(A).

¹⁶⁶ I.R.C. § 170(h)(1)(B).

¹⁶⁷ I.R.C. § 170(h)(1)(C).

¹⁶⁸ I.R.C. § 170(h)(1)(C).

¹⁶⁹ I.R.C. § 170(h)(2); see Treas. Reg. § 1.170A-14(b) (2).

¹⁷⁰ I.R.C. § 170(h)(2)(C).

¹⁷¹ Treas. Reg. § 1.170A-14(b)(2).

¹⁷² Treas. Reg. § 1.170A-14(g)(2).

¹⁷³ Specifically, four categories of organizations qualified for purposes of receiving qualified conservation contributions are: (1) any governmental unit described in Section 170(b)(1)(A)(v); (2) any publicly supported charitable organization described in Section

the conservation purposes of the contribution¹⁷⁴ and have the resources necessary to enforce the conservation restrictions placed on the property.¹⁷⁵ Therefore, private foundations are not permitted to receive qualified conservation contributions.¹⁷⁶

iii. Permitted Conservation Purposes

A qualified conservation contribution must be made for one or more of the following conservation purposes:¹⁷⁷ preservation of land areas for outdoor recreation by, or education of, the general public;¹⁷⁸ protection of a relatively natural habitat for fish, wildlife, or plants, or similar ecosystems;¹⁷⁹ preservation of open space, including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy, provided such preservation will yield a significant public benefit;¹⁸⁰ and preservation of a historically important land area or a certified historic structure.¹⁸¹

The first permitted purpose is preservation of the land area for public recreation or education, which requires public access to the land.¹⁸² This may entail a public access landing for access to lake property for fishing or boating purposes, or a public nature or hiking trail through the property.¹⁸³ While the recreational or educational use of the land by the public must be “substantial and regular,”¹⁸⁴ this does not mean that the public must have unlimited access.¹⁸⁵ For example, public access limits on the number of people using the property at one time, or during periods of repair or maintenance, bad weather, or at night should be acceptable.¹⁸⁶ How-

170(b)(1)(A)(vi); (3) any publicly supported charitable organization described in Section 501(c)(3) that meets the requirements of Section 509(a)(2); and (4) a support organization described in Section 501(c)(3) that meets the requirements of Section 509(a)(3) which is controlled by a governmental unit or a publicly supported charitable organization. I.R.C. § 170(h)(3).

¹⁷⁴ Treas. Reg. § 1.170A-14(c)(1).

¹⁷⁵ Treas. Reg. § 1.170A-14(c)(1).

¹⁷⁶ See I.R.C. § 170(h)(3).

¹⁷⁷ I.R.C. § 170(h)(4)(A); see Treas. Reg. § 1.170A-14(d)(1).

¹⁷⁸ I.R.C. § 170(h)(4)(A)(i); see Treas. Reg. § 1.170A-14(d)(1)(i), (d)(2).

¹⁷⁹ I.R.C. § 170(h)(4)(A)(ii); see Treas. Reg. § 1.170A-14(d)(1)(ii), (d)(3).

¹⁸⁰ I.R.C. § 170(h)(4)(A)(iii); see Treas. Reg. § 1.170A-14(d)(1)(iii), (d)(4).

¹⁸¹ I.R.C. § 170(h)(4)(A)(iv); see Treas. Reg. § 1.170A-14(d)(1)(iv).

¹⁸² Treas. Reg. § 1.170A-14(d)(2)(ii).

¹⁸³ Treas. Reg. § 1.170(A)-14(d)(2)(i); see Priv. Ltr. Rul. 87-13-018 (Dec. 23, 1986) (ruling that taxpayers' grant of 150 acres and 100 acre lake improved with 200 campsites and a picnic area accommodating 350 people satisfied conservation purpose of preservation of land for public outdoor recreation).

¹⁸⁴ Treas. Reg. § 1.170(A)-14(d)(2)(ii).

¹⁸⁵ 4 Richard R. Powell, Powell on Real Property § 34A.04[3][c][i], at 34A-31-34A-32 (June 2000).

¹⁸⁶ *Id.*

ever, "it is clear that the public must have access to the property on a consistent basis."¹⁸⁷

The second permitted purpose involves the preservation of relatively natural habitats of animal or plant communities or similar ecosystems.¹⁸⁸ These properties must contain valuable habitats or ecosystems, such as habitats for rare, endangered, or threatened species of animals, fish, or plants, or other natural areas, such as undeveloped islands, that represent high quality examples of either land- or water-based communities.¹⁸⁹ Other natural areas qualifying under this purpose would be areas contributing to the ecological viability of a local, state, or national park, preserve, wildlife refuge, wilderness area, or similar conservation area.¹⁹⁰ This second permitted purpose has one distinct difference from the first. Because the focus of the second permitted purpose is on protecting natural habitat or ecosystems, public access to the property may be restricted without jeopardizing the deduction.¹⁹¹

The third permitted purpose is the preservation of open space, including farmland and forest land.¹⁹² To satisfy this requirement, the conservation contribution must satisfy one of two alternative requirements. The first alternative is preservation pursuant to a clearly delineated federal, state, or local governmental conservation policy.¹⁹³ The second alternative is preservation for the scenic enjoyment of the general public.¹⁹⁴ Regardless of which alternative is satisfied, the preservation must yield a significant public benefit.¹⁹⁵ A limit on public access to property preserved for "open space" will not cause the contribution to be ineligible unless the conservation purpose would be undermined or frustrated without public access.¹⁹⁶ An example of a contribution that would yield a significant public benefit would be preservation of forest land along a public highway pursuant to a government program to maintain the scenic view from the highway.¹⁹⁷ To qualify as a "scenic easement" there must be visual (rather than physical) access by the public to or across the scenic features of the property.¹⁹⁸

¹⁸⁷ *Id.*

¹⁸⁸ Treas. Reg. § 1.170A-14(d)(3)(i).

¹⁸⁹ Treas. Reg. § 1.170A-14(d)(3)(ii).

¹⁹⁰ Treas. Reg. § 1.170A-14(d)(3)(ii).

¹⁹¹ Treas. Reg. § 1.170A-14(d)(3)(iii).

¹⁹² I.R.C. § 170(h)(4)(A)(iii); Treas. Reg. § 1.170A-14(d)(4).

¹⁹³ Treas. Reg. § 1.170A-14(d)(4)(i)(A).

¹⁹⁴ Treas. Reg. § 1.170A-14(d)(4)(i)(B).

¹⁹⁵ Treas. Reg. § 1.170A-14(d)(4)(iv) (listing numerous factors for this facts and circumstances analysis, with no one factor determinative).

¹⁹⁶ Treas. Reg. § 1.170A-14(d)(4)(iii)(C).

¹⁹⁷ Treas. Reg. § 1.170A-14(d)(4)(iv)(B); see Rev. Rul. 64-205, 1964-2 C.B. 62 (the predecessor to Tax Code authority for conservation easements).

¹⁹⁸ Treas. Reg. §§ 1.170A-14(d)(4)(ii)(B), 14(d)(5)(iv)(A).

The fourth permitted purpose is the preservation of a historically important land area or a certified historic structure.¹⁹⁹ This may include independently significant land areas and historic sites and land areas that contribute to the cultural importance of historic structures or districts.²⁰⁰ Examples of significant land areas are “an archaeological site or a Civil War battlefield with related monuments, bridges, canons, or houses” and any land within or, under certain circumstances, adjacent to a historic district.²⁰¹

If an owner donates her property through a conservation easement for historical preservation, she must provide the public with some visual access.²⁰² The entire property does not have to be visible, but the public must have enough visual access to realize a benefit.²⁰³ Where the historic property is not visible (e.g., the structure is hidden by a wall or shrubbery, or is too far away from a public road), the terms of the easement must provide that the general public will have access to the property on a regular basis.²⁰⁴

iv. Exclusive Use for the Permitted Conservation Purposes

The final requirement of a qualified conservation contribution is that the property must be used exclusively for one or more of the permitted conservation purposes.²⁰⁵ The managed harvesting of timber from forest land along a public highway might be justified because it does not detract from the purpose of maintaining the scenic view.²⁰⁶ In fact, proper maintenance could enhance the permitted conservation purpose. However, if the forest land may be put to a use that is inconsistent with the permitted conservation purpose, the charitable contribution will not qualify for a tax deduction.²⁰⁷

To take an example: Zoe owns a large tract of undeveloped forest land along a public highway. She proposes to donate a perpetual easement to a qualified organization. The easement will ensure that the scenic view from the highway is preserved forever. The easement will prevent any future development of the property for any other commercial uses and restrict use of the property to its forest land uses. This should qualify as a permitted conservation purpose. However, if any harvesting of the timber injures or destroys any significant naturally occurring ecosystem,

¹⁹⁹ Treas. Reg. § 1.170A-14(d)(5).

²⁰⁰ A certified historic structure is listed in the National Register or is located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to the district. I.R.C. § 170(h)(4)(B).

²⁰¹ Treas. Reg. § 1.170(A)-14(d)(5)(ii).

²⁰² Treas. Reg. § 1.170(A)-14(d)(5)(iv)(A).

²⁰³ Treas. Reg. § 1.170(A)-14(d)(5)(iv)(A).

²⁰⁴ Treas. Reg. § 1.170(A)-14(d)(5)(iv)(A).

²⁰⁵ I.R.C. § 170(h)(5).

²⁰⁶ Treas. Reg. § 1.170A-14(d)(4)(iv)(B).

²⁰⁷ Treas. Reg. § 1.170A-14(e).

the contribution would not be considered made for exclusively conservation purposes, and the tax deduction would not be allowed.²⁰⁸

If the grantor of a conservation easement retains a qualified mineral interest,²⁰⁹ the contribution will not be deemed exclusively for conservation purposes unless certain mining activities are prohibited by the easement.²¹⁰ Mining methods, other than surface mining, that have only a limited or localized impact on the land are acceptable if they do not irretrievably destroy significant conservation purposes.²¹¹ If the production facilities are concealed or compatible with the existing landscape and any damage to the landscape will be restored to its natural state, the deduction also is allowed.²¹²

b. Fair Market Value of the Donated Conservation Easement

The value of the donated conservation easement is the fair market value of the perpetual conservation restriction at the time of the contribution.²¹³ The Tax Court has approved charitable contribution deductions for conservation easements ranging from sixteen to ninety-one percent of the value of the protected property.²¹⁴ Because the fair market value of the donated easement is subjective, the government provides strict rules for its determination.²¹⁵ The Treasury Regulations stipulate: "If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the sales prices of such comparable easements."²¹⁶ If no substantial record of sales is available to use as a meaningful or valid comparison (which is most likely the case),

²⁰⁸ Treas. Reg. § 1.170A-14(e)(2).

²⁰⁹ For purposes of this provision, the term "qualified mineral interest" means subsurface oil, gas, or other minerals, and the right to access such minerals. I.R.C. § 170(h)(6). If the rights were retained because the mineral and surface interests were separated before June 13, 1976 and remain separated as of the date of the contribution, and actual mining is so remote as to be negligible, the Tax Code allows a deduction. I.R.C. § 170(h)(5)(B)(ii); Treas. Reg. § 1.170A-14(g)(4)(ii)(A). If the surface interests were separated after June 12, 1976, no deduction is permitted unless surface mining on the property is completely prohibited. Treas. Reg. § 1.170A-14(g)(4)(ii)(B).

²¹⁰ The extraction or removal of minerals by any surface mining method or any other mining method that is inconsistent with the particular conservation purpose of the gift must be prohibited under the easement. Treas. Reg. § 1.170A-14(g)(4)(i).

²¹¹ Treas. Reg. § 1.170A-14(g)(4)(i).

²¹² Treas. Reg. § 1.170A-14(g)(4)(i).

²¹³ Treas. Reg. § 1.170A-14(h)(3)(I).

²¹⁴ C. Timothy Lindstrom, *The Tax Benefits of Conservation Easements*, 79 MICH. B. J. 690 (2000); see also Browne, Jr. & Van Dorn, *supra* note 149, at 70 n.4 (citing court cases providing discounts ranging from 85% to 100% of property values); Ruth S. Flynn & H. Kay Cross, *A Home Where the Bighorn Roam*, LEGAL TIMES, Apr. 14, 1997, at S38 (noting that studies have shown valuation reductions in conservation easement-burdened land ranging from 5% to 95%).

²¹⁵ See Treas. Reg. § 1.170A-14(h)(3)(I).

²¹⁶ Treas. Reg. § 1.170A-14(h)(3)(I).

the fair market value of the easement is equal to the difference between the fair market value of the property before the easement and the fair market value of the property after the easement.²¹⁷

These market values must be substantiated by a qualified appraisal made not more than sixty days before the date of the grant of the easement and not later than the due date for the return in which the deduction is claimed.²¹⁸ The property values before and after the easement must reflect the property's potential highest and best uses.²¹⁹ A property's potential highest and best use can be derived from comparable sales of existing or potential future uses for the property that yield the greatest value.²²⁰ The appraisals must include an objective assessment considering "how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use."²²¹

If the grant of the easement has the effect of increasing the value of any other property owned by the landowner or a related person, the value of the contribution must be reduced by the amount of any increase.²²² In addition, if the landowner receives in exchange for the easement either a cash payment or some other service or property, including a zoning change or development right approval, the deduction will be reduced by the value of the benefit received or completely disallowed if any significant conservation purposes are undermined.²²³

c. Limits on Charitable Donations of Conservation Easements

Once the value of the charitable contribution is determined, the taxpayer must determine the amount of the annual allowable deduction. Charitable contribution deductions are subject to numerous limitations. Charitable contribution deductions are an itemized deduction from a taxpayer's adjusted gross income ("AGI").²²⁴ A taxpayer is allowed to offset her gross income with the greater of either her standard deduction amount or her itemized deductions.²²⁵ If her statutory standard deduction exceeds the total of her itemized deductions, then the taxpayer receives no economic benefit from her itemized deductions, including any charitable contribu-

²¹⁷ Treas. Reg. § 1.170A-14(h)(3)(I).

²¹⁸ Treas. Reg. § 1.170A-13(c)(3)(i)(A).

²¹⁹ Treas. Reg. § 1.170A-14(h)(3)(ii).

²²⁰ See Gen. Couns. Mem. 34,886 at 10-11 (May 25, 1972).

²²¹ *Id.*

²²² Treas. Reg. § 1.170A-14(h)(3)(i) (under this analysis a person is a related party if a related party under Section 267(c)(4)).

²²³ Treas. Reg. § 1.170A-14(e)(2), -14(h)(ii).

²²⁴ I.R.C. § 63(a), (b), (d) (2000).

²²⁵ I.R.C. § 63(e).

tion deductions. In addition, high-income taxpayers are subject to a cutback of their aggregate itemized deductions.²²⁶

If a taxpayer elects to itemize her deductions, her charitable contribution deduction of a conservation easement is limited annually to thirty percent of a taxpayer's AGI.²²⁷ Any charitable contribution deductions in excess of thirty percent of a taxpayer's AGI may be carried forward for up to the next five tax years.²²⁸ A taxpayer can elect to deduct up to fifty percent of her annual AGI by limiting her charitable contribution deduction to the value of the conservation easement reduced by any appreciation of the property above its tax basis.²²⁹ This election would most likely be used in cases where the actual tax basis of the property is near the pre-easement valuation for recently acquired property.

To take another example: Assume that Ariel imposes a qualifying conservation easement on her Wisconsin forest land in 2002. Ariel purchased the forest land in 1982 for \$30,000. The easement reduces the value of her forest land from \$500,000 to \$150,000 (or by \$350,000). In 2002, Ariel's AGI is \$100,000. Ariel's allowable charitable contribution deduction in 2002 is \$30,000 (30% of \$100,000); \$320,000 of her charitable contribution must be carried forward to tax years 2003–2007. If Ariel is not able to use all of her charitable contribution deduction because of her AGI limitation in tax years 2003–2007, she will lose the tax benefit of any remaining balance. If Ariel elected to use the fifty percent AGI limitation, her charitable contribution deduction would be zero because her \$350,000 charitable contribution would be reduced by the \$470,000

²²⁶ Some itemized deductions are specifically excluded from this cutback (e.g., gambling losses), but charitable contribution deductions are included in cutback itemized deductions. I.R.C. § 68 (2000).

²²⁷ I.R.C. § 170(b)(1)(C)(i) (2000). On April 9, 2003, the U.S. Senate passed the CARE Act of 2003, S. 476, 108th Cong., 1st Sess. § 106 (2003). 149 CONG. REC. 374, S5007-44 (daily ed. Apr. 9, 2003). The bill, among other things, provides several additional incentives for qualifying donations of conservation easements. The bill increases the thirty percent AGI limit to fifty percent (without any adjustment to the amount of the charitable deduction) and the five-year carryforward period to fifteen years. In addition, farmers and ranchers whose gross income from farming is at least fifty-one percent of their gross income will not be subject to any AGI limit on their conservation easement donations. Before it becomes law, if ever, the bill must be considered and approved by the House of Representatives and signed by the President. See Land Trust Alliance, *Senate Approves Conservation Tax Incentives for Landowners*, available at http://www.lta.org/public_policy/care_success.htm (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review); Executive Office of the President, Office of Management and Budget, *Statement on CARE Act*, 2003 TAX NOTES TODAY 69–69 (Apr. 10, 2003) (stating that while the administration appreciates the bill's conservation tax incentives, it will work with Congress to ensure these incentives are consistent with the President's budget).

²²⁸ I.R.C. § 170(b)(1)(C)(ii). See discussion *supra* note 227 (discussing possible extension of carryforward period from five years to fifteen years).

²²⁹ I.R.C. § 170(b)(1)(C)(iii) (stating that the election to use the 50% AGI cap limits the deduction to the value of the contribution reduced by any long-term capital gain (that is, the fair market value of the property less the tax basis of the property)). See discussion *supra* note 227 (discussing possible increase of AGI limit to fifty percent without any adjustment to the amount of the charitable deduction).

appreciation of her property since 1982. Now assume the same facts above except Ariel purchased her forest land in 2000 for \$450,000. If Ariel elected to use the fifty percent limitation, her total eligible charitable contribution deduction would be \$300,000 because her \$350,000 charitable contribution would be reduced by the \$50,000 appreciation of the property since 1982; she would be allowed to deduct \$50,000 in 2002 (50% of \$100,000). Two hundred fifty thousand dollars of her charitable contribution would be carried forward to 2003–2007. Ariel should consider careful tax planning to ensure she maximizes the income tax benefits from her conservation easement.²³⁰

2. Estate Tax Benefits

In addition to the income tax charitable contribution deduction available for conservation easements, Congress has provided two estate tax benefits for qualifying conservation easements.²³¹ The first estate tax benefit is that the property protected by a conservation easement is included in the decedent's estate at its fair market value at the time of her death including any decrease in value resulting from the easement.²³² The second estate tax benefit is an election to exclude from the decedent's estate and any estate tax up to forty percent of the remaining value of any property subject to a qualifying conservation easement.²³³

a. Requirements for Exclusion of Remaining Property Value from Estate Tax

Congress enacted this partial exclusion from estate tax in 1997 to facilitate preservation of environmentally significant land by easing "existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes."²³⁴ The partial exclusion provides significant addi-

²³⁰ However, if the CARE Act of 2003, passed by the U.S. Senate on April 9, 2003, is passed by the House of Representatives and signed into law by President Bush, Ariel will not have to engage in this analysis. CARE Act of 2003, S. 476, 108th Cong., 1st Sess. § 106 (2003). Ariel will enjoy the fifty percent AGI limit (without any reduction in the amount of her charitable contribution deduction) and a fifteen year carryforward period. See discussion *supra* note 227.

²³¹ See I.R.C. §§ 2031(a) (2000) (setting forth that a decedent's gross estate includes the value of all property owned at the time of her death), 2031(c) (describing the forty percent exclusion from a decedent's gross estate of the value of property subject to a conservation easement).

²³² I.R.C. §§ 2031, 2051 (2000).

²³³ I.R.C. § 2031(c); see generally Lindstrom & Small, *supra* note 146, at 1171 (providing detailed description of partial exclusion from the federal estate tax for the value of land subject to a qualifying conservation easement).

²³⁴ STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 at 78 (Comm. Print 1997). This estate tax exclusion applies to decedents dying after December 31, 1997 and is estimated to have a federal revenue effect of a \$7 million reduction in 1999, \$15 million in 2000, \$25 million in 2001,

tional estate tax benefits to encourage the donation of conservation easements to stall over-development in the United States.²³⁵

The Tax Code provides an election to exclude up to forty percent of the value of “land subject to a qualified conservation easement”²³⁶ from a decedent’s gross estate.²³⁷ As a result, a decedent excludes this value from her taxable estate and any estate tax. For example, assume a decedent owned land subject to a conservation easement at her death valued at \$1,000,000. The decedent’s executor may elect to exclude from her estate up to \$400,000 of the land and not owe any estate tax on the excluded value.²³⁸ If the election is made, the excluded portion of the property subject to the easement will retain its basis and will not be increased to its fair market value as of the date of the decedent’s death.²³⁹

To qualify to elect the exclusion, a conservation easement must satisfy all of the requirements under Tax Code Section 170(h),²⁴⁰ discussed above, as well as numerous additional requirements.²⁴¹ These require-

\$35 million in 2002, \$48 million in 2003, \$51 million in 2004, \$56 million in 2005, \$60 million in 2006, and \$64 million in 2007. *Id.* at 81.

²³⁵ See John A. Bogdanski, *Enough Already With the Breaks for Conservation Easements*, 78 TAX NOTES 1569 (1998) (describing the exclusion as “opening the door for a double-benefit” and questioning whether the new provision is an “embarrassing technical mistake”); C. Timothy Lindstrom & Stephen J. Small, *This Is Why Conservation Easements Deserve Tax Incentives*, 79 TAX NOTES 130 (1998) (responding to Professor Bogdanski by noting that Congress was motivated to provide more tax incentives by data showing that four square miles of farmland is developed per day and that one-third of Oregon (Professor Bogdanski’s home state) forest landowners were over seventy-five years old); John A. Bogdanski, *New Tax Benefits For Conservation Easements Still Questioned*, 78 TAX NOTES 500 (1998) (setting forth examples of how generous the tax benefits are for conservation easements relative to other charitable contributions and continuing to question whether Congress made a technical error and enacted an unintended benefit).

²³⁶ I.R.C. § 2031(c)(0).

²³⁷ The election must be made on the estate tax return and is due no later than the estate tax return’s extended due date. I.R.C. § 2031(c)(6).

²³⁸ See I.R.C. § 2031(c). Assuming the decedent granted a conservation easement many years before she died, which reduced the value of her land at that time from \$2,400,000 to \$900,000, the decedent enjoyed a charitable contribution deduction of \$1,500,000 during her lifetime. Therefore, the conservation easement reduced the decedent’s taxable estate by at least \$1,900,000 of value (the excluded amount of \$400,000 plus the \$1,500,000 reduction from the land’s pre-easement fair market value plus any foregone appreciation because of the easement).

²³⁹ I.R.C. § 1014(a)(4) (2000).

²⁴⁰ See I.R.C. § 2031(c)(8)(B) (2000). Under this definition, a “qualified conservation easement” is a “qualified conservation contribution (as defined in Section 170(h)(1)) of a qualified real property interest (as defined in Section 170(h)(2)(C)).” *Id.* However, the exclusion does not apply to easements when the sole purpose of the easement is historic preservation and the exclusion applies only to land and not to structures. See I.R.C. §§ 2031(c)(1)(A), (c)(8)(B), 170(h)(4)(A)(iv) (2000).

²⁴¹ I.R.C. § 2031(c)(8). Section 551 of EGTRRA eliminated the requirement under I.R.C. § 2031(c)(8)(A)(i) that the land be located in or within 25 miles of: a metropolitan area (as defined by the Office of Management and Budget); national park, or wilderness area, designated as part of the National Wilderness Preservation System (unless it is determined that by the Secretary that land in or within twenty-five miles of such a park or wilderness area is not under significant development pressure); or in or within ten miles of an Urban National Forest (as designated by the Forest Service). Pub. L. No. 107-16,

ments include: a three year family ownership requirement;²⁴² a requirement that the easement must have been made by the decedent, a family member, the executor, or the trustee of the trust holding the property no later than the date of the election;²⁴³ and a requirement that the easement must prohibit more than de minimis commercial recreational activity use.²⁴⁴ The decedent or a member of the decedent's family²⁴⁵ must have owned the property protected by the conservation easement at all times for at least three years prior to death.²⁴⁶ In addition, the decedent, a member of the decedent's family, the trustee of a trust holding the restricted land, or the executor of the decedent's estate must have granted the easement.²⁴⁷ However, the easement can be placed on the property and donated at any time on or before the date of the election, including after the decedent's death by the decedent's executor, regardless of whether the decedent made any provision for such easement during her lifetime or through her trust or will.²⁴⁸ This provision allows post mortem easement donations.²⁴⁹

§ 551(a), 115 Stat. 38, 86 (codified at 26 U.S.C. 2031(c)(8)(A)(i) (2001)). This elimination is effective for estates of decedents dying after December 31, 2000. *Id.* Therefore, there is no current geographic limitation for qualifying conservation easements. However, all provisions in Title V of EGTRRA (which includes this geographic limitation) do not apply to estates of decedents dying after December 31, 2010 (Section 901 of EGTTRA). STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND DESCRIPTION OF PROPOSALS RELATING TO FEDERAL INCOME AND ESTATE TAX PROVISIONS THAT IMPACT LAND USE CONSERVATION AND PRESERVATION at 11 (Comm. Print 2001). Therefore, these geographic limits will be reinstated and will apply to estates of decedents dying after December 31, 2010 unless Congress extends or makes the repeal permanent. Although the geographic limitations appear restrictive, "it is believed that [they] cover about half of the land in the forty-eight contiguous states and almost all of the land on the East and West Coasts." White, *supra* note 20, at 114 (quoting Ronald Aucutt in 1997 Tax Law Changes: Selected Provisions of Interest to Estate Planners And Their Clients 26 (1997), available in WESTLAW at SC28 ALI-ABA 753); see Lindstrom & Small, *supra* note 146, at 1180-81 (describing broad interpretation of the geographic limitation as including the area twenty-five miles outside of the boundary of the metropolitan area, which itself includes the urban area and its surrounding counties).

²⁴² I.R.C. § 2031(c)(8)(A)(ii).

²⁴³ I.R.C. § 2031(c)(8)(A)(iii).

²⁴⁴ I.R.C. § 2031(c)(8)(B).

²⁴⁵ The Tax Code defines "member of the decedent's family" for this purpose as a decedent's spouse; ancestors; lineal descendants of the decedent, spouse or parent of the decedent; and spouses of such lineal descendants. I.R.C. §§ 2031(c)(8)(D), 2032A(e)(2) (2000). Thereby, a family can pass the benefits of the exclusion from one generation to another. Lindstrom & Small, *supra* note 146, at 1175-76. Moreover, the decedent can hold the property subject to the easement indirectly through a partnership, corporation, or trust if the decedent owns at least a thirty percent interest in the entity. I.R.C. § 2031(c)(10); see also Stephen J. Small, *Understanding the Conservation Easement Estate Tax Provisions*, 87 TAX NOTES 435, 438-39 (2000) (describing certain tax consequences of holding property subject to conservation easements through a corporation).

²⁴⁶ I.R.C. § 2031(c)(8)(A)(ii).

²⁴⁷ I.R.C. § 2031(c)(8)(A)(iii).

²⁴⁸ I.R.C. § 2055(f) (2000); see also Lindstrom & Small, *supra* note 146, at 1174-75 (discussing post mortem election).

²⁴⁹ *But see* Small, *supra* note 245, at 437-38 (noting that families should not rely on post mortem provisions to protect valuable family land or to address estate tax matters).

A post mortem easement does not qualify for any income tax benefits, but can provide significant estate tax benefits.²⁵⁰ Time is essential with respect to planning and placing the post mortem easement, because the estate must elect to take the exclusion within fifteen months of the decedent's death.²⁵¹ If the exclusion is elected, the excluded portion of the property subject to the conservation easement will retain its basis and will not be increased to fair market value in the hands of the heirs.²⁵² If a decedent has a taxable estate it will probably make sense to elect the exclusion, because any built-in gain will be subject to tax at a maximum long-term capital gain tax rate of twenty percent, rather than the generally higher marginal estate tax rates.²⁵³ If a decedent does not have a taxable estate, it will in most cases not make sense to elect the exclusion.²⁵⁴

If the conservation easement retains limited development rights, the property will qualify for the exclusion, but the value of any development rights²⁵⁵ will not qualify for any exclusion.²⁵⁶ If the heirs agree to terminate any retained development rights within nine months, the exclusion will apply to the value of the terminated rights.²⁵⁷ The heirs have until the earlier of two years or the date of sale of the property to effect the termination.²⁵⁸ If they fail to terminate any development rights within such pe-

²⁵⁰ *Id.* at 435–39 (describing numerous tax benefits of post mortem easements).

²⁵¹ The exclusion is an election and must be made on or before the due date for filing the estate tax return, including extensions. The election is made on the estate tax return. I.R.C. §§ 2031(c)(6), 6075(a), 6081 (2000) (setting forth extended due date of estate tax return as 9 months plus a 6 month extension).

²⁵² I.R.C. § 1014(a)(4) (2000).

²⁵³ *See* I.R.C. §§ 2001(c) (2000) (setting forth estate tax rate schedule and lowest marginal rate of eighteen percent on taxable estates under \$10,000 and twenty percent on taxable estates from \$10,000 to \$19,999 and increasing thereafter), 1(h)(1)(C) (2000) (setting forth maximum long-term capital gain tax rate as twenty percent); *see also* Lindstrom, *supra* note 214, at 690; Lindstrom & Small, *supra* note 146, at 1175–76 (setting forth numerical example demonstrating benefits of election in most taxable estate cases).

²⁵⁴ *See* Lindstrom, *supra* note 214, at 690; Lindstrom & Small, *supra* note 146, at 1175–76.

²⁵⁵ For this purpose, a “development right” is defined as “any right to use the land subject to the qualified conservation easement in which such right is retained for any commercial purpose which is not subordinate to and directly supportive of the use of such land as a farm for farming purposes.” I.R.C. § 2031(c)(5)(D) (2000); STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 78–81 (Comm. Print 1997) (setting forth the following as examples of farming activities that are not development rights: tree farming; ranching; viticulture; and the raising of other agricultural or horticultural commodities).

²⁵⁶ I.R.C. § 2031(c)(5)(A); *see* Lindstrom & Small, *supra* note 146, at 1176–78 (discussing implications of retained development rights).

²⁵⁷ I.R.C. § 2031(c)(5)(B). “This provision appears to allow the estate to recalculate the estate tax as though such rights had never been retained in the easement agreement.” Lindstrom & Small, *supra* note 146, at 1177 (setting forth numerical example demonstrating the benefits of this recalculation). Therefore, the easement is revalued and the estate is reduced by the increased easement value as well as by an exclusion of the remaining land value. *Id.* at 1176–78.

²⁵⁸ I.R.C. § 2031(c)(5)(C).

riod, estate taxes on the development rights will be immediately due and payable.²⁵⁹

An easement that retains more than a de minimis right to use the land for commercial recreational use does not qualify for the exclusion.²⁶⁰ The Joint Committee on Taxation has stated that rights retained to grant “hunting or fishing licenses” on the land protected by the easement are de minimis,²⁶¹ but major commercial use for golf courses or ski resorts would not be de minimis.²⁶² Through this limitation, Congress intends to encourage open space preservation for conservation purposes such as scenic open space or habitat, rather than for commercial recreational purposes.²⁶³

The exclusion applies to the individual granting the easement and any member of the decedent’s family.²⁶⁴ As a result, this estate tax benefit will apply to all family members of the decedent who hold the property protected by the easement at their death.²⁶⁵ The estate tax benefits continue generation after generation until the property leaves the donor’s family.²⁶⁶

b. Amount of Exclusion of Remaining Property Value

The maximum amount of the exclusion is the lesser of \$500,000²⁶⁷ or up to forty percent of the value of the land subject to the conservation easement.²⁶⁸ To get the maximum exclusion, the easement must reduce the fair market value of the protected property by at least thirty percent²⁶⁹ because the Tax Code reduces the forty percent exclusion by two percentage points for each percentage point (or fraction thereof) of value

²⁵⁹ I.R.C. § 2031(c)(5)(C). It is arguable that no interest is due on the tax payment, because the tax liability arises at such time and is not due at an earlier time. See Lindstrom & Small, *supra* note 146, at 1177.

²⁶⁰ I.R.C. § 2031 (c)(8)(B).

²⁶¹ STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 78–81 (Comm. Print 1997).

²⁶² See Lindstrom & Small, *supra* note 146, at 1178.

²⁶³ *Id.*

²⁶⁴ I.R.C. § 2031(c)(8)(A)(iii), (c)(8)(C).

²⁶⁵ For this purpose, a “family member” is broadly defined as an ancestor of the individual; a spouse; a lineal descendant of the individual, of the individual’s spouse, or of a parent of the individual; or the spouse of any lineal descendant. I.R.C. §§ 2031(c)(8)(C), 2032A(e)(2) (2000).

²⁶⁶ See Lindstrom & Small, *supra* note 146, at 1175 (setting forth example of multi-generational tax benefits).

²⁶⁷ This amount was phased in over time beginning at \$100,000 in 1998; \$200,000 in 1999; \$300,000 in 2000; \$400,000 in 2001 and \$500,000 in 2002 and thereafter. I.R.C. § 2031(c)(3). The \$500,000 limitation is for each decedent dying after 2001 and not per parcel, therefore if the property is owned by a sufficient number of owners the \$500,000 limit may not preclude recognizing the full forty percent exclusion. See Lindstrom, *supra* note 214, at 690; see also Lindstrom & Small, *supra* note 146, at 1174 (suggesting that with proper planning spouses could exclude jointly up to \$1,000,000 of land value).

²⁶⁸ I.R.C. § 2031(c)(1).

²⁶⁹ I.R.C. § 2031(c)(1), (2); See Lindstrom & Small, *supra* note 146, at 1178–80 (proposing that the thirty percent threshold is intended to ensure that only meaningful easements qualify).

reduction below thirty percent.²⁷⁰ For example, if the reduction in fair market value from placing a conservation easement is only fifteen percent, the exclusion will be limited to ten percent of the reduced fair market value of the property.²⁷¹ The exclusion is calculated by using the value of the protected property (reduced by any outstanding acquisition indebtedness)²⁷² multiplied by the exclusion percentage.²⁷³

If a conservation easement satisfies the necessary requirements,²⁷⁴ the decedent's estate will benefit by the reduction in value of the protected land and, if elected, a forty percent exclusion of the reduced value from estate taxes, up to a maximum of \$500,000. In addition, if a donor granted a conservation easement before her death, she will have already received income tax benefits through a charitable contribution deduction.

3. Property Tax Benefits

Conservation easements may also generate real property tax benefits for landowners. Generally, real property taxes are ad valorem taxes.²⁷⁵ Local governments impose and assess real property taxes based upon the fair market value of the real property.²⁷⁶ The conservation easement restricts the "highest and best use" of land, resulting in lower fair market values and lower assessed values, which in turn can lead to lower property tax costs for landowners. Although each state can and does determine how a conservation easement impacts its property tax values and assessments, as of 1997, at least twenty-four states mandated that property tax values must be determined by including the impact of any conservation easement.²⁷⁷

²⁷⁰ I.R.C. § 2031(c)(2).

²⁷¹ $[40 - 2(30 - 15)] = 10$.

²⁷² I.R.C. § 2031(c)(4)(A)–(B). "Acquisition indebtedness" means the amount of any unpaid indebtedness incurred by the donor in acquiring the property, or incurred before the acquisition to facilitate the acquisition, or incurred after the acquisition for the purchase and was reasonably foreseeable; or extension, renewal, or refinancing of acquisition indebtedness. *Id.* Because debt reduces a decedent's gross estate, I.R.C. § 2053(a)(4) (2000), Congress enacted the acquisition indebtedness limitation to avoid a double deduction for an exclusion on debt-financed land subject to a conservation easement. *See* Lindstrom & Small, *supra* note 146, at 1182 (setting forth discussion and numerical example of acquisition indebtedness limitation).

²⁷³ *See* I.R.C. § 2031(c)(1) (2000) (describing the mechanics of calculating the excluded value which may not exceed \$500,000 for tax years 2002 and thereafter).

²⁷⁴ The conservation easement must satisfy all the requirements under Tax Code Section 170(h) and additional requirements under Section 2031(c)(8). For a detailed discussion of these requirements see *supra* Part II.D.1.a(i)–(iv) and note 151 and accompanying text.

²⁷⁵ Property taxes are *ad valorem* taxes, which are taxes assessed based upon the value of the property. *See* William H. Hoffman, James E. Smith, Eugene Willis, West Federal Taxation, Individual Income Taxes 2003 at 1–6.

²⁷⁶ *Id.*

²⁷⁷ John L. Hollingshead, *Conservation Easements: A Flexible Tool for Land Preservation*, 3 ENVTL. LAW. 319, 359–60 (1997); *see also* Daniel C. Stockford, *Property Tax Assessment of Conservation Easements*, 17 B.C. ENVTL. AFF. L. REV. 823, 824 (1990).

In addition, approximately forty states possess laws that reduce property taxes for forested property.²⁷⁸ These property tax reductions are intended to counteract economic pressures on private landowners to mismanage their forests.²⁷⁹ In many states, forest property landowners who agree to reforest, properly harvest their timber, and not develop are exempt from property taxation for up to thirty years.²⁸⁰ Because property taxes are generally assessed and paid annually, permanent reduction in or lengthy abatement of a landowner's annual real property taxes can save her and her heirs significant out-of-pocket costs over their multi-generation holding period.

The income, estate, and property tax benefits of a conservation easement discussed above can offset and even exceed a private landowner's loss of property value.²⁸¹ Moreover, a private landowner can tailor her conservation easement to meet her financial and other particular needs. The public benefits of conservation easements are everlasting and far less expensive and intrusive than an outright purchase of the landowner's property.²⁸² These incentives and attractive characteristics have attributed to the proliferation of conservation easements.²⁸³

III. HYPOTHETICAL PRIVATE FOREST LAND CASE: KEEPING TREES OUT OF A TREE MUSEUM, PARADISE UNPAVED, AND MONEY IN THE BANK

A. *History of the Forest Land and Landowners*

Ariel and Zoe are sisters who grew up in rural Wisconsin, sixty miles from a large sprawling urban metropolis, Minneapolis, Minnesota.²⁸⁴ Their great-grandparents were hard-working dairy farmers from Norway and Denmark who immigrated 100 years ago to western Wisconsin. During the last 100 years, the family accumulated significant land holdings to

²⁷⁸ Lundmark, *supra* note 2, at 798–801.

²⁷⁹ *Id.* at 799; see Williamson, *supra* note 53, at 508 (describing property tax benefits through the Wisconsin Forest Crop Law program); WIS. DEPT. OF NAT. RESOURCES, Forest Management Guidelines, at 226 available at <http://www.dnr.state.wi.us/org/land/forestry> (describing current Wisconsin forest tax program in which 2,600,000 acres and 27,000 landowners receive average rate reductions of eighty percent in their property taxes down to \$1.74 per acre in exchange for entering into a twenty-five- or fifty-year mandatory and recommended forestry plan) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

²⁸⁰ Lundmark, *supra* note 2, at 799–801.

²⁸¹ Lindstrom, *supra* note 214, at 690.

²⁸² See Tapick, *supra* note 16, at 259–60.

²⁸³ *Id.*

²⁸⁴ See Kyle Gustafson, Sierra Club North Star Chapter, *An Analysis of Sprawl in Six Minnesota Communities*, at ii (Oct. 1999), available at http://www.minnesota.sierraclub.org/sprawl_report_1999.htm (noting that in Minnesota sprawl consumes over sixty-five acres of open space each day resulting in a vast sea of strip malls and parking lots and that between 1982 and 1994 the amount of time lost in Minneapolis traffic jams increased 178%) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

support their cows, sheep, pigs, and other livestock and, of course, children, grandchildren, and great-grandchildren. After the death of the grandparents, the farm operations ceased, but the land, forest, and wildlife flourished, and the farm remained in the family. In 2001, the sisters' parents died, and Ariel and Zoe jointly inherited their family land. Now each owns an undivided one-half interest in 1000 acres, consisting of 80 acres of the original farmland and 920 acres of forest land. The forest land borders a navigable river, which is part of a major watershed system eventually emptying into the Gulf of Mexico and the Atlantic Ocean. The property is part of a critical ecosystem that provides a habitat for numerous wildlife species, including a pair of nesting trumpeter swans, beaver, otter, osprey, loons, geese, turkey, deer, bear, wolves, and numerous bald eagles. The watershed area surrounding the river has an important role in keeping the river water pure and clean. In addition, traversing the river by canoe, boat, or kayak is very popular with the general public because the surrounding forest land provides a rare opportunity for majestic scenery, magnificent wildlife, and idyllic serenity.

Ariel and Zoe, now practicing lawyers in nearby Minneapolis, decide that they would like to retain their family land, but want to minimize their escalating annual property taxes and other property maintenance costs. Ariel, a tax attorney, is interested in developing a portion of the property and cashing in on the alluring real estate boom. Zoe, a land use lawyer, is adamant that the property must be preserved in its natural state to save the wildlife and the river and to abate the fast-spreading urban sprawl of Minneapolis. The sisters engage in numerous debates until they agree upon a mutually acceptable plan.

B. A Plan To Align Economic Interests of Private Forest Landowners and Conservationists

The following plan demonstrates how the tax benefits presented above can align the economic interests of private forest landowners and the preservation goals of conservationists.

1. The Conservation Easement

Ariel and Zoe agree to grant a 1000-acre conservation easement on their land to the Apple River Land Conservancy. Ariel and Zoe structure the conservation easement to satisfy all of the requirements to maximize their income, estate, and property tax benefits.²⁸⁵ The conservation easement significantly restricts their development rights and all of their com-

²⁸⁵ The sisters will structure the conservation easement to satisfy the requirements for a "qualified conservation contribution," I.R.C. § 170(h) (2000), and a "qualified conservation easement," I.R.C. § 2031(c) (2000) to maximize their income and estate tax benefits.

mercial recreational rights.²⁸⁶ They agree that the use of the property will be limited to scenic and ecological conservation purposes in perpetuity.²⁸⁷ Under the terms of their heavily negotiated easement,²⁸⁸ they retain their interests in the oil, gas, and mineral deposits located in the property.²⁸⁹ However, the easement prohibits the extraction of minerals by any surface-mining method and any other mining method that is inconsistent with the conservation purpose of the gift. The easement further restricts the surface use of the property to its current farmland and timber harvesting activities and the future construction of no more than two homesteads, with ancillary buildings.²⁹⁰ The easement also limits the location of the two homestead sites to areas that will not impinge on the scenic beauty afforded to anyone utilizing the public's right to navigate the river as a public waterway.²⁹¹ Ariel and Zoe further stipulate that any impact from oil and gas drilling will be temporary and localized and that the drilling will not interfere with the purpose of protecting the waterway's scenic beauty and the ecosystem's habitat and watershed.

a. Income Tax Benefits

If Ariel and Zoe have complied with all of the requirements of Tax Code Section 170(h), they are entitled to a charitable contribution deduction. The amount of the deduction is determined by the value of the easement, which is generally the difference between the fair market value of the property before and after the easement is placed on the property.²⁹² Determining the fair market value prior to the easement requires considering prior zoning restrictions and restrictions mandated by environmental laws as well as the commercial development potential of the property.²⁹³ The fair market value after the easement must take into account the foregone development value imposed by the restrictions as well as any development or other rights that have been left intact.²⁹⁴

²⁸⁶ See I.R.C. § 2031(c)(5), (c)(8)(B).

²⁸⁷ See I.R.C. § 170(h)(5)(A).

²⁸⁸ For an excellent guide on drafting conservation easements, see Maureen Rudolph and Adrian Gosch, *Comment: A Practitioner's Guide to Drafting Conservation Easements and the Tax Implications*, 4 GREAT PLAINS NAT. RESOURCES J. 143 (Spring/Summer, 2000).

²⁸⁹ See I.R.C. § 170(h)(6).

²⁹⁰ See Treas. Reg. § 1.170A-14(f) (2002), Examples (2), (4); see also Lindstrom & Small, *supra* note 146, at 1176 (suggesting that retaining the right to maintain or establish residences and ancillary buildings to be used by the landowners should not be considered development rights because there is no commercial purpose).

²⁹¹ See Treas. Reg. § 1.170A-14(f), Examples (2), (4).

²⁹² See Treas. Reg. § 1.170A-14(h)(3)(i).

²⁹³ See Treas. Reg. § 1.170A-14(h)(3)(ii).

²⁹⁴ See Treas. Reg. § 1.170A-14(h)(3)(ii).

Ariel and Zoe hire an experienced qualified appraiser²⁹⁵ who timely produces a qualified appraisal.²⁹⁶ The appraisal establishes that the fair market value of their forest land before the easement was \$1,000,000—predominantly due to the significant residential suburban development value of the property. After the easement is placed on the land, the appraisal establishes that the fair market value has been reduced to \$250,000, taking into consideration the foregone development value imposed by the restrictions. Therefore, the owners are entitled to a \$750,000 charitable contribution deduction subject to the thirty percent AGI limitation and the five-year “carryforward” rules.²⁹⁷ Assuming a thirty-five percent marginal tax rate,²⁹⁸ the \$750,000 income tax deduction will provide a \$262,500 income tax benefit in 2002 through any necessary carryforward period.²⁹⁹

Because of the magnitude of their charitable contribution deduction, Ariel and Zoe may be subject to the thirty percent AGI limit in the year of the contribution and in each of the five carryforward years.³⁰⁰ To enjoy the full benefit of their \$750,000 charitable deduction they will each (together with their spouses) have to generate an AGI (that is, salaries, interest and dividend income, net capital gains, etc.) of at least \$208,333 per year.³⁰¹ If this limitation causes a loss of charitable deductions, each sister may independently decide to elect the fifty percent AGI limitation. The election may reduce their charitable contribution deduction but would increase their AGI limit to fifty percent. Assuming their tax basis in their property is \$900,000, their charitable contribution would be reduced from \$750,000 to \$650,000.³⁰² Under the election, they will each have to gen-

²⁹⁵ Treas. Reg. § 1.170A-13(c)(5) (setting forth detailed requirements for a qualified appraiser).

²⁹⁶ Treas. Reg. § 1.170A-13(c)(3) (setting forth detailed requirements for a qualified appraisal).

²⁹⁷ I.R.C. § 170 (2000).

²⁹⁸ See I.R.C. § 1(i).

²⁹⁹ $\$750,000 \times .35 = \$262,500$. This income tax benefit will be enjoyed by the sisters for 2002 and, if they are subject to the thirty percent AGI limitation, in years 2003 through 2007. I.R.C. § 170(d)(1).

³⁰⁰ However, if the CARE Act of 2003 passed by the U.S. Senate on April 9, 2003 is passed by the House of Representatives and signed into law by President Bush, the sisters will enjoy a fifty percent AGI limit (without any reduction in the amount of their charitable contribution deduction) and a fifteen-year carryforward period. CARE Act of 2003, S. 476, 108th Cong., 1st Sess. § 106 (2003). See discussion *supra* note 227.

³⁰¹ $\$750,000/6$ (charitable deduction allowed in year of contribution plus five-year carryforward period) = $\$125,000/2$ or $\$62,500$ each. $\$208,333$ AGI $\times .30$ limit = $\$62,500$ annual charitable deduction.

³⁰² Because Ariel and Zoe recently inherited their property, their tax basis is equal to \$900,000 (assumed fair market value of the property at the date of their parents' deaths). I.R.C. § 1014(a)(1) (2000). With the election, the amount of their charitable contribution would be reduced to \$650,000 (the amount of the charitable contribution of \$750,000 reduced by \$100,000 (\$1,000,000 minus \$900,000, the amount of appreciation in the property over its tax basis)), I.R.C. § 170(b)(1)(C)(iii), but the increased AGI limit of fifty percent may accelerate the recognition of the deduction to earlier years and avoid the loss of any deduction not allowed under the thirty percent AGI limitation. See also I.R.C. § 170(e)(1) (2000).

erate an AGI of at least \$108,333 to enjoy the full benefit of the reduced charitable deduction.³⁰³ If either sister projects a loss of charitable deduction under the thirty percent AGI limits that would be greater than any projected loss of charitable deduction under the elected fifty percent AGI limit, she should make the election.³⁰⁴ Each sister will have to make six-year tax projections to determine which approach maximizes her overall tax benefits.

b. Estate Tax Benefits

Ariel and Zoe may also reap some estate tax benefits from placing the conservation easement on the land.³⁰⁵ If either of them has a taxable estate,³⁰⁶ the land in her estate will be valued at the lower fair market value with the easement in place³⁰⁷—something that could provide a considerable estate tax saving. In addition, the Tax Code provides a federal estate tax exclusion of up to forty percent of the remainder value excluding the value of any retained development rights.³⁰⁸ The reduced value and the exclusion will be determined at their respective dates of death.³⁰⁹ Using the most conservative assumption that the property values do not increase above their current values, and assuming a value of \$50,000 for retained development rights, the benefits will be \$750,000 reduced estate value due to the easement and \$80,000 exclusion of the remaining value.³¹⁰ At

³⁰³ $\$650,000/6$ (charitable deduction allowed in year of contribution plus five-year carryforward period) = $\$108,333/2$ or $\$54,167$ each. $\$108,333$ AGI \times .50 limit = $\$54,167$ annual charitable deduction.

³⁰⁴ For example, Ariel projects her average annual AGI in 2002 through 2007 will be \$100,000. Under the thirty percent AGI limit, her total allowable charitable deduction would be \$180,000 [$\$100,000$ AGI \times .30 limit = $30,000 \times 6$ years] (of \$375,000 [$\$750,000 \times .5$] available charitable deduction) and under the elected fifty percent AGI limit, her total allowable charitable deduction would be \$300,000 [$\$100,000$ AGI \times .50 limit = $50,000 \times 6$ years] (of \$325,000 [$\$650,000 \times .5$] available charitable deduction). Ariel should make the fifty percent AGI election. However, Zoe projects her average annual AGI in 2002 through 2007 will be \$200,000. Under the thirty percent AGI limit, her total allowable charitable deduction would be \$360,000 [$\$200,000$ AGI \times .30 limit = $60,000 \times 6$ years] (of \$375,000) and under the elected fifty percent AGI limit, her total allowable charitable deduction would be \$325,000 [$\$200,000$ AGI \times .50 limit = 100,000 allowed in 2002, 2003, 2004 and \$25,000 in 2005] (of \$325,000). Zoe should not make the fifty percent AGI election.

³⁰⁵ Whether or not the estate tax will exist when Ariel's or Zoe's gross estate matures is not determinable at this time. EGTRRA has repealed the estate tax for decedents dying after December 31, 2009. However, all provisions in Title V of EGGTRA (which includes the provisions regarding the repeal of the estate tax) are scheduled to expire for estates of decedents dying after December 31, 2010. However, President Bush has recently proposed that Congress permanently repeal the estate tax. See President Bush, *supra* note 53.

³⁰⁶ See I.R.C. § 2051 (2000) (defining taxable estate).

³⁰⁷ See I.R.C. § 2031(a) (2000).

³⁰⁸ I.R.C. § 2031(c)(2).

³⁰⁹ See I.R.C. § 2031(a), (c)(1).

³¹⁰ \$750,000 is the reduction in the value of the property after the sisters grant their easement. \$80,000 is the forty percent exclusion of the \$200,000 remaining property value ($\$1,000,000$ less $\$750,000$ excluding the value of $\$50,000$ of retained development rights).

federal estate tax rates as high as forty-nine percent in 2003,³¹¹ the estate tax benefits for both sisters would be as great as \$407,000.³¹²

c. Property Tax and State Tax Benefits

In addition, Ariel and Zoe should enjoy reduced annual out-of-pocket Wisconsin real property tax costs. If Ariel and Zoe enroll in the Wisconsin Managed Forest Law ("WMFL") and subject their property to a forestry plan for a twenty-five- or fifty-year period, they will reduce their annual property taxes.³¹³ Under the WMFL, annual property tax rates are \$1.74 per acre (less if an owner provides public access to her land) representing an average savings of eighty percent from original property tax rates.³¹⁴ For 1000 acres, this would reduce the sisters' annual property tax expense by \$7,000, from approximately \$8,740 to \$1,740.³¹⁵

Moreover, they should enjoy state income tax benefits from their donation of the conservation easement. If we assume the sisters reside and work in Minneapolis, Minnesota, their 2002 marginal Minnesota income tax rate is a maximum rate of 7.85%.³¹⁶ Therefore, their state income tax benefits from their donation of the conservation easement would be almost \$60,000.³¹⁷ In addition, on February 11, 2002, a Minnesota state representative introduced a bill to provide a state income tax credit equal to fifty

³¹¹ See I.R.C. § 2001(c)(2)(B) (West Supp. 2003).

³¹² $(\$750,000 + \$80,000) \times .49\%$ assumed estate tax rate = \$406,700.

³¹³ WIS. DEP'T OF NAT. RESOURCES, *supra* note 7, at 226; see also Williamson, *supra* note 53, at 508 (noting that the Wisconsin Forest Crop Law reduces the forest owner's real estate taxes to \$32.40 per forty-acre parcel when the owner enrolls her forest land in the program).

³¹⁴ WIS. DEP'T OF NAT. RESOURCES, *supra* note 7, at 226.

³¹⁵ The WMFL property tax value of \$1.74 per acre represents an average decrease in the property tax rate of eighty percent. *Id.* Therefore, the sisters' pre-program property tax would be approximately \$8.74 per acre $(\$8.74 - 7.0 (8.74 \times .80) = \$1.74)$ or \$8,740 per year $(\$8.74 \times 1000 \text{ acres})$.

³¹⁶ The 2002 individual income tax rates for Wisconsin and Minnesota range from 5.35% to 7.85%. For Tax Rate Schedules for individual taxpayers resident in Minnesota, see Minnesota Department of Revenue, 2002 Minnesota indexed income tax rate brackets, at <http://www.taxes.state.mn.us/individ/taxinfo/010925inctxrates02.html> (last visited Apr. 27, 2002) (on file with the Harvard Environmental Law Review).

³¹⁷ $\$750,000 \text{ charitable donation} \times .0785 \text{ marginal state tax rate} = \$58,875$. Under current Minnesota income tax rules, residents compute Minnesota taxable income from their federal taxable income after numerous adjustments. The federal deduction for a conservation easement is not one of the required adjustments and therefore is allowed for Minnesota income tax purposes. See 2002 Minnesota Individual Income Tax Forms and Instructions, at http://www.taxes.state.mn.us/individ/forms/2002/pdf/m1_bk.pdf (not providing any adjustment for a charitable donation of a conservation easement) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review); Minnesota Department of Revenue, Revenue Analyses for the 2003/2004 Legislative Session (S.F. 2876 at Revenue Analyses for 2001-2002 Legislative Session For Senate Files), at <http://www.taxes.state.mn.us/reports/fiscal/analyses2002/sf2876-1.pdf> (stating that under current Minnesota tax law, the donation of a conservation easement may be treated as a charitable contribution deduction reducing federal taxable income, which is used for state income tax purposes) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

percent of the value of a donated conservation easement.³¹⁸ If enacted and applicable to their conservation easement, this new state tax credit would provide the sisters with an additional \$375,000 state tax benefit. Moreover, they should also receive annual Minnesota income tax benefits from their reforestation expenditures. Therefore, their lifetime income, estate, and property tax benefits could be significantly greater than \$669,500,³¹⁹ or well in excess of the value of the easement of \$750,000.

2. *Plans for Reforestation*

The second part of the sisters' negotiated plan is reforestation, maintenance, and harvesting of their forest. Ariel desires to profit from their timber, and Zoe desires to keep their forests flourishing. These goals are not mutually exclusive. A selective managed cut of timber every ten to fifteen years improves the health and productivity of a forest.³²⁰ Ariel and Zoe agree to spend \$20,000 (\$10,000 each) for site preparation, seedlings, and planting equipment (qualifying as reforestation expenditures)³²¹ in December 2002 and \$2,000 (\$1,000 per person) each year in December thereafter to maintain and continue the forest growth. For any aggregate reforestation costs above \$20,000 in 2002 and \$2,000 each year thereafter, Zoe agrees to apply for any available government reimbursements and cost-sharing.

a. *Income Tax Benefits*

Ariel analyzes their tax benefits for their reforestation expenditures and makes the following determinations. Because of their long-term holding plans and their current higher marginal income tax rates relative to their projected future lower marginal income tax rates during their retirement years, they will not elect to include any reimbursements in income.³²² Their qualifying reforestation expenditures will provide annual tax credits and amortization deductions.³²³ In 2002, Ariel and Zoe each will take

³¹⁸ Minnesota Department of Revenue, Revenue Analyses for the 2003/2004 Legislative Session (S.F. 2876 at Revenue Analyses for 2001-2002 Legislative Session For Senate Files), at <http://www.taxes.state.mn.us/reports/fiscal/analyses2002/sf2876-1.pdf> (setting forth brief description of the proposed 50% tax credit for contributions of conservation easements and cost analysis) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

³¹⁹ \$262,500 (income tax benefit) + \$407,000 (estate tax benefit) = \$669,500.

³²⁰ WIS. DEP'T OF NAT. RESOURCES, *supra* note 7, at 31, 36 (stating that intermediate thinnings every ten to fifteen years are used to maintain optimum tree levels, growth, and vigor, and that normal cutting cycles range from eight to twenty years); *see also* Williamson, *supra* note 92, at 258-59.

³²¹ I.R.C. § 194(c)(3) (2000).

³²² *See* discussion *supra* note 139 and accompanying text; I.R.C. § 126(c) (2000) (setting forth election to include excluded payments in gross income).

³²³ *See* I.R.C. §§ 194, 48(b) (2000).

a \$679 reforestation amortization deduction and \$1,000 reforestation tax credit.³²⁴ The combined tax credit and amortization deduction will provide each sister with a \$1,238 tax savings.³²⁵ In 2003 and afterwards, the annual reforestation tax credit will be \$100 each,³²⁶ and the reforestation expenditure deduction will be \$1,425 each,³²⁷ increasing by \$136 each year³²⁸ until 2008 when the deduction will reach \$2,105.³²⁹ In 2009 and 2010, the reforestation amortization deductions will drop to \$1,563 and \$952 respectively.³³⁰ For tax years after 2002, Ariel and Zoe will each have annual out-of-pocket costs of \$1,000 and annual tax benefits from ranging from \$837 to \$433.³³¹

b. Financial Gains

After ten years (in 2013), Ariel and Zoe will harvest a portion of their mature timber. They plan to enter into a managed cutting contract with an experienced local logging company that will keep their forest healthy and green and their bank accounts full.³³² The revenue for their trees will more than reimburse them for all of their reforestation expenditures and could be approximately \$420,000.³³³ The gain they will recognize from

³²⁴ $\$10,000 - \500 (reforestation expenditures less half of the \$1,000 reforestation tax credit)/84 x 6 months (one-half year convention irrespective of when Ariel and Zoe made their expenditures) = \$679 reforestation expenditure amortization. I.R.C. § 194(a). $\$10,000 \times .10 = \$1,000$ reforestation tax credit. I.R.C. § 48(b).

³²⁵ $\$1,000 + .35(\$679) = \$1,238$.

³²⁶ $\$1,000 \times .10 = \100 . I.R.C. § 48(b).

³²⁷ $\$9,500/7$ (yearly amortization for 2002 \$10,000 reforestation expenditure less half of the \$1,000 reforestation tax credit) + $\$950/84 \times$ six months (half-year convention applied to amortization for \$1,000 of reforestation expenditures less half of the \$100 reforestation tax credit) = \$1,425.

³²⁸ $\$136 = \$950/7$ (yearly amortization of \$1,000 of reforestation expenditures less half of the \$100 reforestation tax credit).

³²⁹ $\$2,105 = (\$9,500/7 + \$950/84 \times 6 \text{ months} + \$950/7 + \$950/7 + \$950/7 + \$950/7 + \$950/7)$.

³³⁰ 2009: $(\$9,500/84 \times 6 \text{ months} + \$950/84 \times 6 \text{ months} + \$950/7 + \$950/7 + \$950/7 + \$950/7 + \$950/7 + \$950/7) = \$1,563$; 2010: $(\$950/84 \times 6 \text{ months} + \$950/7 + \$950/7 + \$950/7 + \$950/7 + \$950/7 + \$950/84 \times 6 \text{ months}) = \952 .

³³¹ Assuming a thirty-five percent marginal tax rate, the amortization provides a high benefit of $\$2,105 \times .35 = \$737 + \$100$ tax credit = \$837 to a low benefit of $\$952 \times .35 = \$333 + \$100 = \433 .

³³² For everything you want to know about managing your private forest, see WISC. DEP'T OF NAT. RESOURCES, *supra* note 7 (including a sample cutting contract and a valuable resource directory listing educational opportunities for woodland owners and managers (e.g., Master Woodland Stewards Program, Wisconsin Woodland Leadership Institute), national programs providing free tree farm management plans, and numerous organizations that support private woodland owners in sustaining and protecting their forests).

³³³ Assuming a mix of various types of oak, walnut, and apple sells for an average of \$300 per 1000 board feet, a managed cut every ten years on 920 acres of forest land could yield approximately 1,400,000 board feet or approximately \$420,000. *See, e.g.*, Williamson, *supra* note 92, at 262 (setting forth estimated net volume of wood on ninety-one acres); Williamson, *supra* note 53, at 509 (setting forth estimated net volume of wood on forty acres); WISC. DEPT. OF NAT. RESOURCES, STUMPAGE RATE—2003, at http://www.dnr.state.wi.us/org/land/forestry/Private/harvest/Curr_stumprt.htm (setting forth 2003 prices (per 1000 board

the sale of their timber³³⁴ will qualify for favorable long-term capital gain treatment, subject to tax at a maximum tax rate of twenty percent.³³⁵ Moreover, because they have waited more than ten years in incurring their initial reforestation expenditures, they will not have any recapture of their reforestation amortization deductions or tax credits.³³⁶ If they have received any government reimbursements or cost-sharing for reforestation expenditures that they excluded from gross income in the past twenty years, they may have to recharacterize a portion of their timber gain as ordinary income instead of capital gain.³³⁷

The sisters have agreed to invest financially in the long-term maintenance and management of their forests. As a result, the forest, river, and wildlife will flourish. Every year they will harvest valuable tax benefits, and every ten to fifteen years they should reap considerable tax-favored financial gains from their managed cut and timber sales. Ariel and Zoe can mutually benefit from this dual-purpose plan.

3. Gratification for Perpetuity

Ariel and Zoe will receive gratification from their conservation easement and forest maintenance and management program beyond their tax benefits and financial gains. Zoe wants to protect her family forest land from Minneapolis urban sprawl development pressures.³³⁸ Zoe also desires to preserve her family homestead and its forests, forest soils, fisheries, wildlife, water quantity and quality, air quality, and scenic beauty.³³⁹ Ariel and Zoe both desire to keep the land in their family for generations.³⁴⁰ This may be more likely if their heirs can realize the tax benefits

feet) for all varieties of wood in different Wisconsin locations ranging from \$459.62 for black walnut to \$143.27 for maple (other than sugar)) (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review). For additional information about the value of timber and how to sell it, see *WHAT IS MY TIMBER WORTH AND HOW DO I SELL IT?*, at <http://www.srs.fs.usda.gov/econ/data/prices/wannano.htm> (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

³³⁴ The gain recognized from the sale will be the amount realized of \$420,000 less the adjusted basis in the timber sold. I.R.C. § 1001 (2000). Because the sisters inherited their property in 2001 when their parents died, their adjusted basis in the trees sold is equal to the fair market value of the trees in 2001. I.R.C. § 1014(a)(1) (2000). Accordingly, the gain recognized and subject to tax could be considerably less than \$420,000.

³³⁵ See I.R.C. §§ 631(b), 1231, 1(h)(1)(C) (2000).

³³⁶ See I.R.C. § 50(a)(1)(B) (2000); Treas. Reg. § 1.194-1(c) (2002).

³³⁷ Treas. Reg. § 16A.126-1(f) (2002).

³³⁸ The Sierra Club has labeled Minneapolis as a sprawl-threatened region. David L. Szlanfucht, *How to Save America's Depleting Supply of Farmland*, 4 *DRAKE J. AGRIC. L.* 333, 334 (1999).

³³⁹ Kadlec, *supra* note 7, at 5 (quoting easement donor as stating that "[o]ur conservation easements assure us that there will be permanent protection of this land for future generations and this puts our minds at ease.").

³⁴⁰ This sentiment is widely held by those who have established conservation easements. Bob McCurdy, *32-Acre Easement*, *CROSSCURRENTS* (Gathering Waters Conservancy, Madison, Wis.), Fall 2002, at 7 (stating that "[i]t is disturbing to see condo complexes overrunning

of the conservation easement rather than being forced to sell the property to pay real property and estate taxes.³⁴¹ A conservation easement allows control of the future use of the property in perpetuity.³⁴² Their long-term plan to invest in their forest's management and maintenance should result in tax-favored financial gains that will allow their heirs to afford to continue their forest management program. The continued investment in the forest will keep the trees, air, river, and wildlife healthy, clean, and flourishing and the encroaching asphalt and sprawl outside of its boundaries.

C. Keeping Trees Out of a Tree Museum and Paradise Unpaved

Ariel and Zoe and thousands of other private landowners across the country have worked with land trusts to protect millions of acres of open space in perpetuity.³⁴³ "This positive change has happened one easement at a time."³⁴⁴ Conservation easements can be granted, for example, on four-, twelve-, fifteen-, or thirty-acre parcels³⁴⁵ and provide tax benefits equal to or in excess of their cost.³⁴⁶

As Ariel and Zoe have demonstrated, a properly designed and executed conservation easement and forest management program can mitigate differences between the economic interests of landowners and the environmental interests of conservationists. More specifically, income, estate, and property tax benefits from reforestation investments and the granting of conservation easements can make it economically feasible for landowners to preserve paradise in lieu of developing parking lots.

IV. CONCLUSION

The numerous tax benefits available to forest landowners confirm that economic conditions are favorable for maintaining and preserving private forest land. Since 1944, Congress has enacted significant tax benefits for forest landowners that provide economic incentives to achieve public envi-

what were once beautiful hillsides of endless orchards or natural woodlands. It is sad to see old people who have lived here for generations having to sell off their homesteads because they can no longer afford to live here, to see habitat being destroyed threatening numerous species of flora and fauna.").

³⁴¹ *Id.*

³⁴² See I.R.C. § 170(h)(5)(A) (2000).

³⁴³ See Seelye, *supra* note 141, at B1. There are more than 1200 nonprofit grassroots land trusts operating in the United States that promote and support voluntary private land conservation. Land Trust Alliance, *About LTA*, available at <http://www.lta.org/aboutlta/index.html> (last visited Apr. 27, 2003) (on file with the Harvard Environmental Law Review).

³⁴⁴ Jocelyn Gretz, *Living Their Conservation Ethics: Landowners Share Their Stories*, CROSSCURRENTS, at 7 (Fall 2002).

³⁴⁵ *Id.* at 6–7 (quoting from donors of 12-, 15-, 32-, and 195-acre conservation easements); West Wisconsin Land Trust, *Three Families & the Lake They Love*, 6 COMMON GROUND, Fall 2002, at 6 (describing conservation easements on 4-, 24-, and 27- acre parcels surrounding Pine Lake).

³⁴⁶ Lindstrom, *supra* note 214, at 690.

ronmental conservation goals. Forest landowners can keep trees out of a tree museum and paradise unpaved through tax benefits for reforestation. Reforestation tax benefits include accelerated expensing of qualifying costs through amortization, the reforestation tax credit, tax-free government reimbursements, and cost-sharing for a portion of reforestation costs.³⁴⁷ Moreover, properly managed and timed timber sales can generate income subject to tax at preferential long-term capital gains tax rates rather than ordinary income.³⁴⁸

With escalating real estate market values and decreasing tax rates, the current income, estate, and property tax benefits of a conservation easement could be at record highs. Moreover, with stock values at record lows, donors should look at their inflated real estate portfolios rather than at their deflated stock portfolios for charitable donations. A charitable donation of a conservation easement is the ultimate gift that keeps on giving.³⁴⁹ The landowner benefits from significant economic incentives and continued ownership of property preserved for perpetuity.³⁵⁰ The public benefits because the fastest growing threat to our quality of life and environment, the paving of paradise, is slowed.³⁵¹

³⁴⁷ See I.R.C. §§ 48(b), 194, 126 (2000).

³⁴⁸ See I.R.C. §§ 631, 1231, 1(h)(1)(C) (2000).

³⁴⁹ I.R.C. §170(h)(5)(A) (2000).

³⁵⁰ See Williamson, *supra* note 53, at 507 (noting that forest property ownership is a multiple use investment providing recreational benefits, wildlife habitat, and a diversified source of income).

³⁵¹ Szlanfucht, *supra* note 338, at 336 (noting that the Sierra Club, along with many Americans, considers suburban sprawl as the fastest growing threat and that the average annual loss of farmland to development is from one to 4.2 million acres).